Value-Added Tax: The Partial Exemption Regime

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PRÉCIS
Cet article traite du régime d’exemption partielle pour les crédits de la taxe sur la valeur ajoutée (TVA) qui est prévu par la sixième Directive du Conseil de l’Union européenne. Certains intrants utilisés par une entreprise contribuent tant aux extrants imposables de l’entreprise qu’aux extrants qui sont exempts d’impôt. En vertu du régime d’exemption partielle, une certaine proportion de ces intrants est attribuée aux extrants qui sont exempts d’impôt—selon une règle donnée de calcul au prorata—et le crédit de TVA ne s’applique qu’aux intrants établis comme contribuant aux extrants qui sont imposables. Toute méthode de calcul au prorata s’écarte dans une mesure plus ou moins grande des principes fondamentaux en matière de fiscalité et est généralement difficile à appliquer.

Le présent article identifie, analyse et classe les méthodes et règles les plus couramment utilisées dans l’UE aux fins de l’exemption partielle de la taxe sur les intrants. La plupart des méthodes choisies ne sont pas stipulées officiellement dans les États membres mais proviennent plutôt d’ententes conclues entre les négociants et les autorités nationales, à la discrétion de la sixième Directive du Conseil de l’UE. L’auteur analyse ici les implications de ces pratiques et évalue les impacts économiques et administratifs des diverses méthodes adoptées au sein des États membres. Il conclut qu’il existe une possibilité d’uniformiser efficacement certains paramètres fondamentaux et usages spécifiques de ces méthodes. Une certaine uniformisation favoriserait une saine concurrence de même qu’une application uniforme de la TVA dans toute l’UE qui soit compatible avec la création d’un marché unique, tout en fournissant une base de référence pour les autres pays de l’OCDE en ce qui a trait aux questions relatives à la TVA.

ABSTRACT
This article addresses the partial exemption regime of the credit type of value-added tax (VAT) provided for by the European Union (EU) sixth council directive. Under this regime, inputs contributing indiscriminately to both the taxable and exempt outputs of a business are apportioned under various approaches, and

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only the tax on inputs relating to taxable outputs is credited. Any apportionment techniques used to this effect inevitably deviate to a greater or lesser extent from the basic principles of the tax and are quite troublesome in operation.

The article identifies, explores, and classifies the most important partial exemption methods and rules for input tax apportionment that are encountered in EU practice. Most of these input tax apportionment approaches are not statutorily specified in the member states, but are the product of agreements between traders and national authorities at the discretion of the EU sixth directive. The article analyzes the issues and traces the effects of these approaches within and across the member states from an economic and administrative standpoint. It is concluded that there is scope for effectively standardizing basic parameters and specific uses of these approaches in the EU. This would promote healthy competition and uniform application of the VAT across the EU consistent with the completion of the single market, and would constitute a basis of reference for the other OECD countries in the field of VAT. **Keywords:** VAT; GST; exemptions; OECD.

### INTRODUCTION: THE CONCEPT OF PARTIAL EXEMPTION

In the second half of the 20th century, the great majority of OECD countries massively adopted the consumption type of value-added tax (VAT). The European Union (EU) was the leading region to proceed to harmonized adoption of the VAT on the legal and administrative basis set out in the sixth council directive. During the 1990s, the central and eastern European countries, having entered into accession agreements with the EU (a status that is short of actual EU membership), adopted the VAT, and after major revisions, have now brought it more closely into line with the sixth directive. Today, all the OECD member countries except the United States apply the tax.

The VAT is chargeable at different positive rates on the goods and services supplied in the course of any business (taxable supplies or outputs) carried out by any natural or legal person (taxable person or trader) at each stage of the production and distribution process. The taxable person pays to the authorities the tax he levies on his supplies (output tax), after deducting the tax charged on his inputs (input tax), which is the tax on goods and services (including capital assets) he purchases from other taxable persons for the purposes of making the taxable supplies. Therefore, unless he sells at less than cost, the input tax he deducts is effectively recharged to his customers and is not lost to the revenue authorities. The tax deduction (or credit) mechanism ensures the avoidance of cascade effects, but can be a potential risk to revenue if applied to purchases that do not contribute to taxable outputs. As for the cross-border supplies of any taxable business, imports are taxed as inputs on the importation, while exports are relieved of tax as zero-rating outputs. This treatment reflects the efficient application of the destination principle under a general consumption tax like the credit-type VAT. The transitional VAT arrangements with respect to the abolition
of border control for the intra-EU supply of goods (effective from January 1, 1993) do not affect the principle. These arrangements, and the approximation of the VAT rates that came into effect on January 1, 1996, pave the way for the prospective changeover to taxation at the place of origin (the origin principle of taxation), which is consistent with the completion of the single market.

Preferential tax treatment is, however, applied to certain supplies in the form of zero-rating or exemption for social, administrative, and other considerations. Zero-rating means that a taxable person is not liable to VAT on the supply of a zero-rated product; he is, however, entitled to recover any VAT incurred on purchases related to this sale. Zero-rating differs from exemption in the sense that a taxable person is not liable to VAT on the supply of an exempted product, nor is he entitled to recover the VAT invoiced to him on purchases related to this product. For strictly administrative reasons, all the VAT-applying countries in the OECD extend the treatment of exempted supplies to any (otherwise positive or zero-rated) supplies of small traders—that is, traders whose annual turnover (from all supplies) falls below specified limits.

The fact that zero-rating gives rise to tax refunds makes it costly from an administrative and revenue standpoint. Thus, the sixth directive and most non-EU countries (such as Japan, Switzerland, and Turkey) confine zero-rating strictly to exports. Allowances have been made, however, for a few EU member states (Ireland, the United Kingdom, Belgium, and Denmark) that, for a traditional reason, extend zero-rating to certain otherwise positive-rated supplies (such as food, transportation, and construction works). The example of these countries has been followed by certain non-EU countries (for example, Canada, Sweden, Norway, New Zealand, Iceland, and Mexico).

The sixth directive distinguishes two categories of exempted supplies. The first category is limited by the status of the profession, trade, or vocation that the persons or bodies have been registered, enrolled, or licensed by the authorities to exercise. This category of exemption consists of activities in the public interest carried out by specific bodies governed by public law (such as health care, education, social and cultural services, and radio and television broadcasts) or by liberal professions (such as dentists and dental technicians, medical practitioners, ophthalmic and dispensing opticians, dispensers of hearing aids, lawyers, and solicitors). The second category encompasses certain distinct supplies of specific sectors of economic activity, not necessarily involving specialized persons or bodies, mainly concerning financial transactions, insurance and reinsurance, immovable property, as well as betting, gambling, and lotteries. Both categories of exemption refer to the supply of goods and services strictly linked to the statutory description thereof. Consequently, all other supplies, independently of the persons or bodies providing them, are taxable: facilities provided to non-patients in hospitals (such as refectory services and sale of pharmaceuticals); commercial radio and television activities (such as advertisements and production and marketing of films); financial activities indirectly linked to banking services.
activities linked to immovable property (such as the provision of hotel accommoda-
dation, the letting of parking space, or the hire of safes). In the case of the second
exemption category (distinct supplies), the sixth directive permits optional taxa-
tion, which member states have adopted in different ways, mainly in the field of
financial transactions (Germany and France) and of letting and leasing of immov-
able property (England).

The Central and Eastern European countries closely follow the sixth direc-
tive’s prescription for the VAT exemption of public interest activities, but still
deviate from the prescription for the exemption of distinct supplies. In addition,
these countries extend the VAT exemptions to a larger field than that specified in
the sixth directive (thus exempting such items as medicines, newspapers, books
and periodicals, passenger transportation, and various other services). More dif-
fences appear in this respect in the VAT systems of other OECD member coun-
tries, which either

• extend exemptions beyond the standard ones of the sixth directive, to
  include, for example, child care, legal aid, ferry, and standard municipal
  services (Canada); social welfare services (Japan); books, newspapers, maga-
  zines, and agricultural, forestry, and fishing activities (Mexico); and pas-
  senger transport, accommodation in hotels, and services of consulting and
  advising (Norway); or

• tax certain items listed as sixth directive standard exemptions, such as the
  supply and leasing of commercial land and buildings (Canada, Japan, and
  Korea), and postal services (Canada, Japan, Finland, New Zealand, and
  Sweden).

The fact that the sixth directive provides for exempt supplies—apart from the
positive-rated (including zero-rated) supplies—gives rise to the partial exemp-
tion phenomenon. A partially exempt person is one whose outputs consist of
both taxable and exempt supplies of goods or services, and who therefore has
the problem of apportioning his input tax between the part attributable to his
taxable supplies that qualifies for deduction and the part attributable to his
exempt supplies that is not deductible since otherwise exempt supplies would
not, in effect, differ from zero-rating. Partial exemption is troublesome in the
VAT countries for both the tax authorities and the business concerned, because
it is very difficult in practice for a taxable person to split his business activities
so as to show precisely which amounts of input tax relate to taxable supplies and
which amounts relate to exempt supplies. There will be inputs that will be indis-
criminately used for both taxable and exempt outputs, so that it would be impos-
sible for any method of apportionment to give fair results.

In this respect, articles 17.5 and 19 of the sixth directive provide for the “pro-
rata” rule as a method for securing a fair and reasonable attribution of input tax
to taxable supplies, by applying the taxable proportion of the total value of outputs to the total input tax and treating the product as the deductible input tax. However, the sixth directive allows the member states to use any version of the pro-rata rule or any other method capable of producing legitimate input tax attribution. Although the pro-rata rule is the prevailing method applied in the EU, the member states in many cases follow a more independent, and consequently less uniform, course of action in this respect. Apart from the pro-rata rule, which is specified in respective national legislation as the standard method, most of the other methods used are the product of agreements between the tax authorities and the individual businesses concerned or their associations. For the other OECD countries, the picture is basically the same, the only difference being the fact that some of them irregularly extend the granting of exemption to the supply of certain other goods and services. This gives rise to additional categories of partially exempt persons. In Canada, for instance, a utility company owned 100 percent by a municipality may be partially exempt, making supplies of goods and services to both the public, which is taxable, and to the municipality (that owns the utility), which is exempt. In such a case, the VAT treatment of the supply (as taxable or exempt) depends on the status of the customer and not on the nature of the supply.

The aim of this article is to examine the possibility of a stricter common policy on this matter for the EU, which could promote the neutrality of the VAT vis-à-vis the conditions of competition between businesses, thus serving the single market goal, and could constitute a basis of reference for the other VAT-applying countries of the OECD. To this end, the article identifies, examines, and formulates the most important partial exemption methods and rules drawn from EU experience. It also addresses the issues and traces the impact of these practices within and across the EU member states from an economic and administrative standpoint.

In effect, there are two alternative principles for apportioning input tax between taxable and exempt outputs when calculating the deductible amount of input tax payable by a partially exempt person. Such an apportionment can be achieved by reference to either the outputs themselves (outputs principle) or the inputs related to taxable or exempt outputs (inputs principle). The provision of rules assigning the right of full input tax deductibility to any partially exempt person with insignificant exempt activities serves compliance and administrative considerations for the traders and the tax authorities respectively. However, the fact that all of these apportionment techniques, to a greater or lesser extent, deviate from the basic principles of the tax, and are quite burdensome in operation, leads to undesirable economic and administrative effects, which hinder the efficiency of the VAT in the EU.
METHODS OF APPORTIONMENT BY REFERENCE TO “OUTPUTS”

The outputs principle of input tax apportionment is based on the pro-rata rule and can be applied either under the pure form of the rule, known as the pure or current outputs method, or under special methods, as specified below.

Pure or Current Outputs Method

The pure or current outputs method is the principal input tax apportionment method, based on the values of VAT-exclusive taxable (including zero-rated) outputs and exempt outputs. For each tax period, the value of taxable outputs is expressed as a percentage of the total outputs. This percentage (the deductible pro-rata proportion) is then applied to total input tax. The result is the deductible input tax, which is to be claimed in the taxpayer’s tax return. The deductible pro-rata proportion applies provisionally at the end of each tax period and is calculated on the basis of the current period’s transactions. The provisional proportion is subject to review and adjustments on the basis of the relevant figures for the year as a whole because of seasonal variations that occur in a taxpayer’s inputs and outputs. This method is most simply illustrated by the following formula:

\[
\frac{\text{Taxable outputs}}{\text{total outputs}} = \frac{\text{Deductible input tax}}{\text{total input tax}}.
\]

The pro-rata rule envisages that the same relationship exists between the value of every output transaction, whether taxable or exempt, and the amount of tax incurred on the related inputs. In practice, this will rarely be the case; consequently, the attribution of input tax will not be exact. The result may well be unfair to the trader, especially if the value of exempt outputs is high, compared with the cost of related inputs. However, the advantage of the pro-rata rule lies in its simplicity. The trader need not analyze his inputs in any special way, as he must under the inputs principle methods described below.

The pro-rata rule in its pure form expresses the actual deductible proportion for the trader, on both a periodical (tax period) and an annual basis. If there are no other reasons (relating to the structure, accounting methods, and nature of the exempted outputs of the trading business) that might require a special method of apportionment, one should expect the pure pro-rata rule to be applied by the majority of the traders concerned. This is true for the year basis calculation. For the tax-period basis calculation, however, all EU countries and many of the Central and Eastern European countries (the Czech Republic, Latvia, Lithuania, and the Slovak Republic) apply a slightly different version of this rule, expressed in the preceding year outputs method described below. Only the United Kingdom, Ireland, and some non-EU countries (Romania, Hungary, and Estonia, for example) apply the current outputs method as their standard method of apportionment (see table 1).
Table 1  Partial Exemption Regimes in the OECD Countries

<table>
<thead>
<tr>
<th></th>
<th>Outputs principle methods (pro-rata rule)</th>
<th>Inputs principle methods(^a)</th>
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<tbody>
<tr>
<td></td>
<td>Current outputs method</td>
<td>Preceding year’s output method (standard method)</td>
</tr>
<tr>
<td>Canada(^b)</td>
<td>(X)</td>
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</tr>
<tr>
<td>Czech Republic</td>
<td>X</td>
<td>—</td>
</tr>
<tr>
<td>Denmark</td>
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<td>X</td>
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<tr>
<td>Finland</td>
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<td>X</td>
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<tr>
<td>Greece</td>
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<td>X</td>
</tr>
<tr>
<td>Hungary</td>
<td>X(^c)</td>
<td>X</td>
</tr>
<tr>
<td>Ireland</td>
<td>X(^d)</td>
<td>X</td>
</tr>
<tr>
<td>Italy</td>
<td>—</td>
<td>X</td>
</tr>
<tr>
<td>Japan</td>
<td>—</td>
<td>X</td>
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<tr>
<td>Luxembourg</td>
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<td>Netherlands</td>
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<td>New Zealand</td>
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<tr>
<td>Portugal</td>
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<td>X</td>
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<tr>
<td>Romania</td>
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<td>Spain</td>
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<td>Sweden</td>
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<td>X</td>
</tr>
<tr>
<td>Switzerland</td>
<td>—</td>
<td>X</td>
</tr>
<tr>
<td>United Kingdom(^h)</td>
<td>X</td>
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</tr>
</tbody>
</table>

\(^a\) These methods are subject to the agreement between the taxable person and the tax authorities. \(^b\) In principle, it is at the option of the registrant to use any reasonably possible apportionment method. The use of any of these methods is verified at the time of audit by the tax authorities. \(^c\) This method is allowed as an alternative of the standard method and the deductible proportion is defined cumulatively, using data from the current-year tax periods. \(^d\) It may be agreed with the inspector as an alternative to the standard method. \(^e\) The administration may authorize the taxable person, on his request, or even force him, to use this method as an alternative to the standard method. \(^f\) This method is allowed by the tax authorities as an alternative to the standard method, if the latter seems inappropriate or unfair and results in a recoverable VAT that is more than 10 percent greater than that calculated on the basis of the alternative. \(^g\) The use of this method is compulsory in those cases in which the use of the standard method leads to an amount of recoverable VAT that exceeds by 20 percent or more the amount resulting from the application of this method. \(^h\) United Kingdom, HM Customs & Excise, “Partial Exemption,” VAT Notice no. 706, February 1999.


Canada is one of the few OECD countries whose legislation does not prescribe any apportionment method but grants the registrant the option of choosing the method to be used. The method chosen must be reasonable, given the registrant’s circumstances. On this basis, the pro-rata rule may be acceptable for determining the extent to which goods and services are, or are intended to
be, used, consumed, or supplied in the course of commercial activities under either the preceding year’s or the current outputs method. The use of the pro-rata rule implies that the revenue generated by an activity will give a reasonable approximation of the use of inputs in that activity. Supporting documentation should address why this rule is appropriate and should deal with possible distorting factors, such as adjustments made to minimize the existence of different profit margins for different products, or other factors mentioned below. An example of the pro-rata application worth noting for Canada is the case mentioned above of a partially exempt utility company owned 100 percent by a municipality, which sells to the public and to the municipality itself at the same price and markup.9

Independently of the version of the pro-rata proportion adopted as to the time dimension of the values of its constituent (provisional) outputs, the calculation and the application base should exclude some values that otherwise might have unfairly affected the amount of the deductible input tax of the partially exempt business. Article 19.2 of the sixth directive provides for the exclusion from the calculation of the taxable pro-rata proportion of certain outputs (disregarded outputs or supplies) that have an incidental character and a very high value compared with the inputs they are related to. Disregarded outputs encompass the exempt supplies of real estate and financial transactions, and the taxable supplies concerning the disposal of capital assets used in the partially exempt business, which might otherwise unfairly reduce or increase, respectively, the deductible input tax. The legislation of the EU member states (and the other VAT-applying countries of the OECD) is relatively consistent with the disregarded exempt outputs provided for by the sixth directive. With respect to capital assets, article 21 of the sixth directive allows member states the option to require a partially exempt person to undertake a five-year adjustment of the total tax paid on capital assets acquired for his business purposes with respect to one-fifth of this total tax. Since capital assets are long-lived assets, annual variations in the deductible proportion applied to the partially exempt person’s business should be taken into consideration. However, some member states (such as the United Kingdom and Ireland) do not require an input tax adjustment on the acquisition of capital assets, while others provide for a waiver of the adjustment if the entitlement for tax deductibility in the adjustment year does not differ from the one in the acquisition year by, for instance, more than 5 percent (Portugal) or 10 percent (the Netherlands), on the grounds that the practical results would be insignificant at a low VAT rate.10 In this case, the disposal of the asset should be included in the partial exemption calculations. Other member states unconditionally require adjustments.

The application base of the deductible pro-rata proportion should not include the tax on certain purchases, which is not allowed for deduction anyway under the normal principles of the fully taxable business regime of the sixth directive. There are two categories of exclusion in this respect. The first is the non-input tax—that is, the tax that in principle is not considered an input tax (relating to
purchases for the purpose of any of the activities that do not constitute a business carried on by the trader). The second is the irrecoverable input tax—that is, the input tax that is defined by the sixth directive as non-deductible for the sake of revenue protection, since it refers to inputs that cannot be confined to strictly business use. The sixth directive specifies some of these inputs (business expenses on luxuries, amusements, or entertainment), but allows the member states the discretion to define any other inputs that may be included. In this respect, the member states present differences in the discretion they exercise. A typical case is the tax incurred on motor car leasing for business use, which is considered either fully (as in Greece, Ireland, and Sweden) or partially (by 50 percent in the United Kingdom and Sweden) irrecoverable.

In the other OECD countries, the differences are even greater and refer to all of the sixth directive categories of irrecoverable input tax. The most developed countries are more diversified and relaxed in this respect. For example, Canada allows a 50 percent deduction of the tax on the entertainment cost; New Zealand provides the same proportion for certain types of entertainment expenses; and Japan does not apply any restrictions on such input tax deductions. In contrast, all the Central and Eastern European countries wholly prohibit the deduction of tax on such expenses as food, drink, tobacco, hotel accommodation, entertainment, passenger cars, and motor fuel. Finally, with respect to the input tax incurred in connection with disregarded exempt outputs, if the tax refers to inputs that are among those that are used indiscriminately for both taxable and exempt outputs, it should be included in the apportionment base. This is for the sake of simplicity; otherwise, the exclusion of such input tax in this case would be unfair to the trader.

Special Output Methods

There are basically three special methods of apportionment under the outputs principle:

1) **Preceding year’s outputs method or standard method.** This method is a version of the current outputs method in the sense that the provisional deductible pro-rata proportion is calculated on the basis of the value of the taxable and exempt outputs in the preceding year. This proportion applies to the total input tax in each tax period of the current year. The amount deducted must in every case be subject to adjustment by the trader when the percentage based on the current year’s outputs is determined. This method can be convenient, or even necessary, if the trader would have difficulty in determining the value of his outputs period by period. On this basis, it could be permissible as a special method or as a way of apportioning residual input tax under the direct inputs attribution method described below.

Administratively, the preceding year’s outputs method appears more attractive than the current outputs method, since, unlike the latter, it saves
traders from the burdensome calculation of a new pro-rata proportion at the end of each tax period of the year. This might have been a convincing argument for the sixth directive (article 19.3) to establish it as the standard apportionment method, and for most of the EU member states and many non-EU countries to adopt it as such.

As article 19.3 of the sixth directive recognizes, however, this method has the disadvantage that in the absence of any exempt outputs in a previous year, or in case exempt outputs were negligible or insignificant, “the deductible proportion shall be estimated provisionally under supervision of the tax authorities, by the taxable person from his own forecast.” This obviously may give rise to administrative problems in arriving at a proportion acceptable to both the trader concerned and the tax department by local negotiation. Furthermore, this proportion will at best be a rough approximation of the trader’s actual proportion calculated at the end of each tax period (on the basis of the transactions of that period). Therefore, it gives rise to cash flow disadvantages either for the trader or for the government, which can be corrected only when the annual adjustment takes place. These arguments appear to have weighed more heavily in countries that adopted the current outputs method as the standard method (see table 1).

2) **Method based on the number of taxable and exempt transactions (or transactions formula).** This is a method of indirect input attribution by reference to outputs. It is suitable for traders, particularly in the finance sector, who have exempt outputs with a high value in comparison with the cost of related positive-rated inputs. For example, when a trader sells securities as a principal and cannot disregard these transactions, the value of the exempt output is the price of the securities, but the input tax attributable to that output may be relatively very small. A trader in this situation who would use the pro-rata rule (under the pure or the standard outputs method) to calculate his deductible input tax would be able to deduct only an unreasonably small proportion of his total tax, because of the high value of his exempt outputs. For this reason, a trader who prefers the simplicity of a proportional method should be allowed to propose one that is not based on the value of his outputs.

The numbers of taxable and exempt transactions provide an acceptable basis for apportioning a block of input tax. This is fair and reasonable only if roughly the same amount of input tax is incurred in connection with each transaction, irrespective of the value and whether it is taxable or exempt. This basis could be approved for use alone or for different sectors of a trader’s business, or to apportion residual input tax in cases where the trader proposes to use a method that consists partly of the direct attribution by reference to inputs method described below, provided that his accounting system can be relied on.

When a trader calculates deductible input tax for each tax period by reference to the numbers of transactions occurring in that period, he should
adjust his deductions in the light of the appropriate figures for the year as a whole. Alternatively, when the calculation is based on figures for the preceding year, the trader must make an adjustment at the end of the first year using this method on the basis of that year’s actual percentage as soon as it has been determined. Thereafter, annual adjustments need not be made unless the trader so wishes. Many VAT countries (for example, the United Kingdom) use this method.

This method would be particularly suitable for stockbrokers according to the sixth directive treatment of their activities. Stockbrokers normally act as agents in stock exchanges, buying and selling securities on behalf of clients and charging them a commission, which is taxable at a positive rate. However, a stockbroker may be partially exempt because he also makes exempt supplies by selling securities as a principal. This will be the case if he acts as an arbitrageur—that is, one who seeks to take advantage of differing market prices in various countries by buying/selling securities in a centre in one country with the intention of selling/buying the same or equivalent securities in a centre in another country. Exempt supplies also arise when a stockbroker sells securities that he had to accept on his own account at the time of purchase because he acted in error on a client’s instructions. Other activities of stockbrokers also give rise to exempt supplies—for example, if they enter into option transactions (receive option money, whether in respect of a buying or a selling transaction), act as money brokers, negotiate loans of money in an agency capacity, receive interest on bank deposits, or rent property. In this case, when the stockbroker sells securities as a principal, their value will usually be very high compared with the value of his taxable outputs. He cannot disregard these sales for the purpose of his partial exemption calculations, or his loan transactions or bank deposits. If, therefore, he used the pure or the standard outputs method to calculate his deductible input tax, the high value of his exempt outputs would enable him to deduct only an unreasonably small proportion of his total input tax. In calculating the number of exempt transactions, he should include both his sales of securities as a principal and all other exempt transactions (since they cannot be considered strictly incidental and hence disregarded exempt supplies). At the end of each tax period, the stockbroker’s firm should make an adjustment based on these figures for the year as a whole. Such a method is provided for under the UK VAT system, subject to the agreement of the local office of Customs & Excise.

3) Method based on the number of staff attributable to taxable and exempt transactions. The number of employed staff engaged in taxable and exempt activities respectively can be the basis, but only if there is a direct and constant relationship between the positive-rated inputs concerned and the staff who use them. This method is permitted in Sweden and Ireland. Provided that the proportion of the total staff employed in each activity does not vary significantly, the numbers of staff on an agreed date in each
tax period or each year can be used. Otherwise, average numbers are to be used. This is also a method of indirect input attribution by reference to outputs, like the previous one. Therefore, the prerequisites for the approval of such a method should be the same as for the previous method, based on the numbers of taxable and exempt transactions.

METHODS OF APPORTIONMENT BY REFERENCE TO “INPUTS”

The inputs principle of input tax apportionment defines a large group of various methods that have emerged from the EU experience. These methods have been proposed and applied as the most suitable by specific types or classes of traders in consultation with the tax authorities of the member states concerned. Care should be taken not to approve any special method that is unrealistic as to the allocation of the trader’s input tax between his exempt and taxable outputs, or which, in practice, may prove to be complicated for the traders to operate or the tax officers to verify. Four of the most interesting inputs principle methods are the following:

1) *Direct inputs attribution method.* This method is appropriate to traders capable of relating actual inputs to taxable and/or exempt outputs and either deducting or not deducting input tax as appropriate. An input need not be related to any particular output, but only to the taxable or exempt category of outputs. Thus, a trader whose business is divided into branches, each dealing solely with taxable or exempt outputs, may be able to identify some goods and services as being for use in one or more branches, the outputs of which are all taxable or all exempt. Any residual amount of input tax that cannot be attributed directly to taxable or exempt outputs may be provisionally apportioned by any acceptable version of the pro-rata rule, subject to any necessary annual adjustment after the end of the trader’s tax year. This method is used by many countries, under the special permission of the national tax authorities (see table 1). The method could be particularly applicable in Canada. On the one hand, registrants are free to use any reasonably possible input-based allocation method including direct allocation (for example, based on square footage, time, or some other directly measurable factor), or the use of an input-based formula to allocate residual inputs that cannot be directly allocated (such as the ratio of inputs directly attributed to taxable activities to total inputs). On the other hand, there is the provision that applies to a company consisting of divisions or branches that have separate accounting systems, and are separately identifiable by virtue of their activities or locations, whereby the company can apply to have these branches file separate goods and services tax (GST) or harmonized sales tax (HST) returns.16

The direct inputs attribution method could be an appropriate alternative to the transactions formula referred above in the case of stockbrokers.
Under this alternative, stockbrokers could attribute their input tax directly to their taxable and exempt supplies whenever possible and use the transactions formula only to apportion their residual input tax. It would still be necessary for the firm to make an annual adjustment of the input tax deducted in accordance with the transactions formula.

Special attention should be given to the effects of non-attribution on either taxable or exempt outputs. If a trader who could attribute some input tax directly to both taxable and exempt outputs were to attribute some input tax directly to taxable outputs but none directly to exempt outputs, he could deduct more of the residual amount than if he had attributed some of the tax directly to exempt outputs. On the other hand, if he were to attribute some input tax directly to exempt outputs without attributing any directly to taxable outputs, he could deduct less of the residual tax. For these reasons, a condition for approval of any special method involving direct attribution should be that the trader must attribute input tax directly to taxable and exempt outputs to the fullest extent practicable and use a proportional method only for inputs that cannot be directly related to either taxable or exempt outputs.

If any input tax incurred in connection with the disregarded exempt outputs (mentioned earlier) can be identified, it must be attributed directly to them so that it is not deducted.

2) Quasi inputs method. This method is designed for traders who acquire positive-rated goods for onward taxable supply without processing or alteration (that is, in the same state) and who can identify them in their records (such as wholesaler’s or retailer’s purchases of goods for resale). The input tax on such goods may be deducted in full, and the rest of the trader’s input tax apportioned by the pro-rata rule as under the pure or the standard outputs method described above. The value of “same state” taxable outputs is to be included in the pro-rata calculation to ensure that a fair proportion of the input tax on overhead expenses is deducted. The total amount of deductible input tax is to be claimed in the trader’s tax return. “In the same state” means that the goods supplied are essentially the same as when they were acquired, and have not been transformed into different goods by applying a treatment or process that may require inputs used both for the exempt and the taxable side of a business. Moreover, the periodical apportionment of the residual input tax (for example, on overhead expenses) under this method should be provisional and subject to annual adjustment as with the standard outputs method.

Some traders buy positive-rated goods for exempt supplies in the same state (for example, ophthalmic or dispensing opticians and dispensers of hearing aids). Under these circumstances, when these traders use the quasi inputs method they must include the input tax on such goods in the total amount that has to be apportioned by the pro-rata rule, and not in the total that is fully deductible by that method. In the EU, however, these traders are
reimbursed, to a greater or lesser degree, in respect of the non-deductible input tax attributable to their exempt supplies made to National Health Service (NHS) clients of the respective member state. These payments are additional to the normal scale fees payable to them. On the other hand, most of these traders make supplies that are taxable at a positive rate, and many carry on their businesses as, for instance, opticians in conjunction with other taxable activity (such as that of a dispensing chemist). In this case, the opticians become partially exempt persons and should include goods for onward taxable supply. When, for instance, an optician uses the pure or the standard outputs method, he is able to deduct a proportion of all the VAT on inputs that relate directly or indirectly to the exempt side of his business. If he used a direct inputs attribution method, he would not be able to deduct any part of the input tax that was directly attributable to his exempt outputs. It is likely, though not certain, that the quasi inputs method may give the most favourable result to the optician. But whatever method he uses, its legal effect is to enable him to deduct only that part of his input tax which is attributable to his taxable outputs, and therefore he is not debarred from making the declaration referred to above when claiming reimbursement from the NHS authorities.

Be that as it may, the quasi inputs method requires more record keeping than the pure or standard outputs method, because the trader must distinguish between “same state” and other inputs. However, this method will always give a more favourable result than the latter to the trader in a position to use it. This is so because any possible unfairness of the pro-rata rule is restricted to a residual amount of input tax (which, referring to inputs not acquired for onward taxable or exempt supply, cannot be attributed directly to either of these supplies). Whether the method will give the trader a better result than any other method applying the inputs principle will depend on the nature of the taxable and exempt activities of his business and the inputs related to each of these activities. Definitely, the method will be unfair to a trader (as in the case of the pure or the standard outputs method) if he has exempt outputs of disproportionally high value. In any case, the quasi inputs method is less fair than any other method using the inputs principle, because the trader cannot claim a full deduction of input tax in respect of capital goods (such as a cash register) and overhead expenses, even though they relate solely to his taxable business. These disadvantages should be weighed against the fact that under this method the trader is able to claim a proportion of the tax on inputs related to his exempt business.

3) **Split quasi inputs or banks’ method.** This method is specially designed for banks. Because of the nature of banking activities, it is technically difficult to subject them to the normal VAT system. According to the sixth directive treatment of banking activities, which is basically followed by all the VAT countries, banks constitute partially exempt persons. In particular, the majority of the financial services provided by banks are in principle exempt
(such as loan and credit facilities, and the transfer and security of money). Positive-rated activities are the non-monetary financial services—that is, those not directly concerned with the provision of financial assistance (such as underwriting issues of securities, debt collection, accounting assistance, investment and other financial advice, safekeeping, management and administration services, including the secondment of staff, and miscellaneous services and goods provided by banks to their customers). The exempt financial services are normally zero-rated when supplied to any recipient (individual or business) in a country outside the EU. Zero-rated activities are monetary financial services when supplied in connection with export activities of specific goods or transshipments for an ultimate destination outside the EU.

The structure of banking activities requires a special approach for input tax apportionment. The outputs arising from a bank’s lending activities (which constitute its main source of income) are very high compared with the cost of the related taxable inputs, but this is not the case with the bank’s other outputs (arising from so-called service charge activities). Therefore, if a bank were to use the pure or the standard outputs method, it would be able to relate only an unreasonably small proportion of its total inputs to taxable supplies (mainly the specialist services commonly performed by banks for their customers).

On this basis, an acceptable approach would be the application of the quasi inputs method as to any direct input tax attribution, coupled with the service charge/lending split of the bank’s outputs for the calculation of the residual input tax. In particular, banks should deduct the whole of the input tax on goods purchased for taxable (including zero-rated) supply in the “same state,” whether or not the onward supply is for a consideration (such as cheque books and their covers, statement covers, travellers’ cheque wallets, cheque card wallets, coin trays and coin cases, savings boxes, and coin globes), and the input tax on handling charges related to the supply of gold bullion. This deductible input tax and any irrecoverable input tax (mentioned earlier) must be excluded from the apportionment calculations. The remaining input tax is the residual tax, which is divided between the service charge income and interest income categories of outputs (excluding any disregarded outputs) as follows:

\[
\frac{\text{Taxable service charge income}}{\text{Total service charge income}} \times a\% \times 100 = k\% \\
\frac{\text{Taxable interest}}{\text{Total interest}} \times b\% \times 100 = g\% 
\]

The total percentage of recoverable input tax is \((k\% + g\%)\) and is provisionally determined in each tax period and subject to annual adjustment. The input tax division \(\frac{a}{b}\) should broadly correspond with the taxable costs actually incurred among the two categories of outputs, although the precise method by which this is carried out is to be specified on various principles.\(^\text{17}\) To achieve that, a bank will have to identify cost centres (such as
occupancy costs, and telephone and data processing costs), allocate expenses among them on the basis of various factors (such as numbers of staff, floor area, salaries, and number of extensions or terminals), and finally apportion these cost-centres expenses between the two output categories either by the direct attribution or the pro-rata rule. The formula $a/b$ should be reviewed whenever there is a significant change of circumstances.

Banks and other financial institutions will likely need to consider some different version of the split quasi inputs method or even to use some version of a direct inputs attribution method. In particular, these methods may be based on the split of the banking output to more than two specific categories or to various specialized departments (such as leasing, property development, and investment services/advisory) as is the case, for instance, in Italy and Ireland (see table 1).

4) **Indirect inputs attribution method.** In some cases, it will not be possible to relate actual inputs directly to taxable or exempt outputs at the time of receipt. However, the trader may propose a formula by which inputs over a period are related to particular taxable and exempt activities, and the tax on them is attributed accordingly. For example, some traders, for their own purposes, periodically allocate expenditure to various branches or departments of their business in order to keep the profitability of each activity under review. Such traders may find it practicable to adapt their accounting systems so that a percentage of their own input tax, based on the previous year’s allocation, is attributed to taxable or exempt outputs. Even if the trader does not already allocate expenditure in this way, he may wish to do so for partial exemption purposes so that he can apportion his input tax more precisely than by using the pro-rata rule. Such a method is explicitly provided for in the United Kingdom and is applied in practice in many member states (such as Sweden, Ireland, and Germany). 18

When this course is practicable and reliable figures are available, or can be specially produced, to show the percentage of input tax that would have been deductible or non-deductible in the preceding year, a special method may be approved by which the trader uses this percentage provisionally to calculate his deductible input tax for the current year, subject to adjustment at the end of the first year. Therefore, a fresh percentage is to be calculated at the end of each year, and this is to be used to calculate deductions in the following year. Annual adjustments need not be made unless the trader so wishes. If this kind of method is adopted, there should usually be no residual tax to apportion. If there is, it should be apportioned as described for the standard method above.

**PARTIAL EXEMPTION WAIVER RULES**

Partial exemption constitutes a serious complication in any VAT system for both traders and tax authorities. The difficulties are enhanced in the case of partially
exempt persons with insignificant exempt outputs in relation to their business as a whole or with insignificant input tax relating to their exempt outputs. Simplification can be achieved through entitlement to full input tax deductibility, and thus to waiver of apportionment, for these traders. Such a waiver could be based on two alternative groups of (maximum) limits specifying, under particular structures, the aforesaid two categories of “insignificant” partially exempt traders respectively. This is the basis for the outputs waiver rule and the inputs waiver rule. The waiver rules are permissible under the general description of article 17.5 of the sixth directive.

Under the outputs waiver rule, the limits should be determined by the tax authorities of any country in such a way that, regarding the number of partially exempt traders and the revenue likely to be involved at various levels of turnover, they achieve the maximum reduction in the number of traders affected by the partial exemption requirements without significant impact on revenue. The limits should apply only annually, when annual adjustment takes place; but their provisional application as well would help to maintain the cash flow either to the traders or to the government, as the case may be. It should be recognized that confinement of the limits to percentage numbers will favour large registered businesses, for which any percentage limit can involve substantial amounts of tax, and thus will give them an unfair advantage over smaller, non-diversified competitors with exempt outputs of the same kind.

On the basis of these considerations, the outputs waiver limits should be a package (for the various classes of business turnover) of an average amount per month (reflecting negligible exempt outputs) coupled with a percentage waiver limit (reflecting insignificant exempt outputs in relation to the total business outputs). In shaping the structure of the package, the national tax authorities should endeavour to avoid an abrupt entitlement to relief among the various turnover classes of businesses, by designing the percentage and quantitative limits in such a way that as the percentage decreases, the quantitative amounts increase.

By its nature, the outputs waiver rule is consistent with the apportionment methods of the outputs principle; thus, the pro-rata rule plays the only, or the most important, role in the apportionment of input tax. The rule should apply at the end of each tax period (provisional application), based on the current or the preceding year’s outputs as the case may be, and at the end of each tax year under the annual adjustment, based on the current year’s outputs. Any disregarded exempt outputs therein should be excluded, for reasons of consistency.

In some instances, the value of a person’s exempt outputs might exceed the aforesaid outputs waiver limits, but the input tax attributable to these outputs might be comparatively small. In this event, the outputs waiver rule should be replaced by an inputs waiver rule, whereby a partially exempt person could also be entitled to full tax deductibility, if the input tax attributable to his exempt outputs would not exceed a small proportion of his total input tax. For the purpose of this calculation, the trader must exclude any irrecoverable input tax that is provided for reasons unconnected with partial exemption. He must also exclude
any input tax that is directly attributable to the disregarded exempt outputs, for the sake of consistency.

For obvious reasons, the inputs waiver rule should be available only to traders using any one of the inputs principle methods. In particular, this rule is appropriate in special cases where the residual input tax relative to total input tax of a partially exempt person is quite small. The reason is that, in such cases, the pro-rata rule \( ([\text{Taxable outputs}/\text{Total outputs}] \times 100) \) plays little part in the determination of the input tax attributable to taxable outputs; therefore, the employment of the outputs waiver rule may misrepresent the significance of the amount of the total input tax attributable to exempt outputs (especially where a person’s exempt outputs might exceed the outputs waiver limits but the input tax attributable to these outputs may be small).

The sixth directive mentions only the inputs waiver rule under the general description of article 17.5.(e), according to which the member states may “provide that where the VAT which is not deductible by the taxable person is insignificant it should be treated as nil.” EU member states, as well as other VAT-applying countries, mainly use the inputs waiver rule (if at all) in a very diversified way. For instance, Sweden provides that if tax liability exists for more than 95 percent of the overall turnover of the business, VAT paid that does not exceed SEK 1,000 for a particular acquisition may be deducted without division on reasonable grounds. Luxembourg provides that the pro-rata proportion does not apply when it is less than 10 percent and the non-deductible amount of VAT does not exceed LUF 10,000 for the calendar year in question. In Greece, full tax liability is allowed if the non-deductible amount of VAT is less than DR 10,000 for each tax period.\(^{19}\) Among the Central and Eastern European countries, only Hungary and Bulgaria apply partial exemption de minimis rules of 10 percent and 5 percent respectively.\(^{20}\) The United Kingdom is perhaps the only country that provides for both waiver rules in an elaborate very profound structure resembling that described above.\(^{21}\) In particular, the inputs waiver rule is provided for the trader, such as a publican or hotelier, who is partially exempt because he provides gaming machine facilities (an exempt activity) but has no other significant exempt outputs. Such a trader may find that, if he uses a special method, only a small proportion of his input tax is attributable to exempt outputs. In this case, he is allowed to use the inputs waiver rule in conjunction with his special method. If a trader is using the quasi inputs method, and the input tax directly and indirectly attributable to his taxable outputs under that method is more than \((1-x)\) percent of his total input tax, where \(x\) stands for the percentage inputs waiver limit, he too could be allowed to use the respective rule. Another typical case in the United Kingdom is that of factoring companies that normally engage in taxable activities (taking over the accounting, credit control, and debt collection of a client trader; guaranteeing payment of outstanding debts by a fixed date), and make only a few exempt supplies (mainly when the factor is prepared, on the acceptance of its customer, to make an immediate advance of a high percentage of the value of the trader’s debts, charging interest on the loan). In this case, the
factoring company would have very little input tax that could be attributed to its exempt supplies; and as a consequence, it should be allowed to choose the inputs waiver rule and be treated as fully taxable.

Nevertheless, for reasons of revenue protection, care should be taken to ensure that when a trader is allowed to use one of the waiver rules, he does so consistently. He should not be permitted to use one rule in some periods and the other rule in other periods, according to whichever is more favourable to him at the time.

**THE EFFECTS OF THE PARTIAL EXEMPTION REGIME**

A uniform, universal, and destination-based VAT of the type set out in the sixth directive is a net consumption tax that is neutral between current and future consumption and between domestic and imported products. Once allowances are made for exemptions and zero-rating and assumptions are relaxed about uniformity and universality of the VAT, the usual argument arises that a selective tax interferes with choice. This imposes excess burden by leading to distortions in consumption (in addition to the distortion of the leisure-labour choice), production, and international trade.

Given the exemption of small traders, the greater the variety in exempt supplies, the greater the damage to the neutrality of the tax. Depending on elasticity and market structure, the non-deductible input tax attributable to the exempt supplies is passed on to their prices in the form of hidden tax. The hidden tax gives rise to double taxation effects if the exempt supplies are at an intermediate stage of the production and distribution process. The extent of these effects depends on, among other things, the number of the taxable stages that the exempt supplies pass through as constituents of taxable final products.

As a result, the hidden tax in the prices of final products breaks consumption neutrality. Also, it distorts domestic production competition to the extent that the value of taxable or exempt outputs of competitive businesses includes, respectively, the hidden tax in their purchases of exempt supplies or the non-deductible input tax related to their exempt outputs. Finally, the hidden tax distorts competition between the EU member states. The products crossing the frontiers may be burdened with a non-rebated hidden tax of their exempt (input) constituent. The size of such a tax varies in accordance with the differing rates (see table 2), incidence, and multistage cascading effects among the origin and destination countries of these products. At present, there is little reliable information provided by member states regarding the extent and the quantum of hidden tax and its ensuing distortions arising from the broad exemptions. However, such distortions do arise in practice, especially in the financial sector.

The hidden tax and its ensuing distortions become more undetermined in the case of the partially exempt persons at any stage of the production and distribution process. This is mainly due to the following three factors:

- First, the input tax apportionment methods do not allow an exact attribution of inputs to their related taxable and exempt outputs and accordingly

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a correct application of the right to an input tax deduction. Under these circumstances, and given the assumption of complete forward tax shifting, the hidden tax may include a larger or smaller amount of the non-deductible input tax than the one actually attributed to the exempt supplies. Any such difference is necessarily counterbalanced by respective self-adjustments to the amount of the deductible input tax (which is considered attributable to the taxable supplies). Differences of this kind are likely to be quite extensive under the pure or the standard outputs methods, in contrast to the special apportionment methods with limited residual input tax.

- Second, additional distorting effects may arise in intra-EU trade from differences among the member states in certain aspects of the determination of the input tax deduction. These differences stem from the discretionary approach of the sixth directive as to the determination of the irrecoverable input tax, the disregarded supplies, the treatment of capital expenses, and the valuation of certain exempt supplies (regarding foreign exchange, commercial paper, etc.), as well as optional taxation or the allowances made for the exemption of certain otherwise exempt or taxable supplies, as applicable.

- Third, there is insufficient specification and non-uniform application of the various versions of the apportionment methods in the member states. This

<table>
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<th>Reduced rate</th>
<th>Standard rate</th>
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<tr>
<td>Canada</td>
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<td>22</td>
</tr>
<tr>
<td>Denmark</td>
<td>—</td>
<td>25</td>
</tr>
<tr>
<td>Finland</td>
<td>8/17</td>
<td>22</td>
</tr>
<tr>
<td>Greece</td>
<td>4/8</td>
<td>18</td>
</tr>
<tr>
<td>Hungary</td>
<td>0/12</td>
<td>25</td>
</tr>
<tr>
<td>Ireland</td>
<td>0/3.3/10/12.5</td>
<td>21</td>
</tr>
<tr>
<td>Italy</td>
<td>4/10</td>
<td>20</td>
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<tr>
<td>Luxembourg</td>
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<td>Japan</td>
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<tr>
<td>Netherlands</td>
<td>6</td>
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<td>New Zealand</td>
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<tr>
<td>Norway</td>
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<tr>
<td>Portugal</td>
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<tr>
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<td>18</td>
</tr>
<tr>
<td>Spain</td>
<td>4/7</td>
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</tr>
<tr>
<td>United Kingdom</td>
<td>0/2.5/5</td>
<td>17.5</td>
</tr>
</tbody>
</table>

\(^a\) 15 percent harmonized sales tax (HST) applies in those provinces that have harmonized their provincial retail sales tax with the federal goods and service tax (GST), which is similar to a VAT. (The 15 percent HST is composed of a provincial component of 8 percent and a federal component of 7 percent.)

may affect the size of the hidden tax in a diversifying way, since the various
apportionment methods imply different tax deductibility and compliance
costs for any given partially exempt business. Potential distortions may
arise with respect to the compliance cost imposed by the partial exemption
regime. In particular, this cost, to a greater or lesser degree, is a constitu-
tent element of the value of the partially exempt business outputs. Among
competitive partially exempt traders, those with sophisticated business struc-
tures and accounting systems are able to comply at lower cost with the
requirements of a given method of apportionment; furthermore, they can
afford to adjust to the requirements of their specific business by using the
most accurate (and probably complicated) special method of apportion-
ment. With respect to the latter, these traders are expected to prefer to use
a method that leaves an insignificant residual input tax for pro-rata appor-
tionment, thus providing a fairer result of their input tax deductibility. In
contrast, less efficient traders mainly adopt the ambiguous pure or stan-
dard method of apportionment for practical or other reasons. Of course, there
are traders who consider it worthless to apply any apportionment method,
thus abandoning their statutory right to an input tax deduction. These are
traders whose deductible proportion of the input tax is relatively small com-
pared with the compliance cost of performing an apportionment calculation.

In principle, any real or potential distorting effects of the partial exemption
regime in the EU might to some extent be restrained by a tighter standardization
of the determinants of the calculation and the application base of the pro-rata
proportion, and a more uniform application of the various versions of the appor-
tionment methods among the various classes of partially exempt businesses in
the member states. This opportunity is recognized by the European Commission,
especially in light of the eventual change from the destination to the origin princi-
ple of VAT for completion of the single market:

Harmonization of many other aspects of the common system of VAT [in addition
to the tax rates] is absolutely necessary. Mention should be made here of topics
such as the extent of and conditions for exercising the right to deduct, exemptions,
the tax treatment of small firms or other special schemes. Although it has not been
possible to achieve significant progress so far, there is no escaping the fact that
these aspects must be harmonized in order to ensure healthy competition and
sufficiently uniform application of the tax across the Union. . . . The entire range
of options, authorizations and derogations allowed by the existing system also
need to be reviewed.24

To this end, the standardization of the pro-rata determination, used either as
main or residual proportion, is quite straightforward.

The uniform application of apportionment methods could be pursued by group-
ing the partially exempt businesses into broad classes on the basis of effective
criteria and specifying for each class the uniform application in the EU of the
most appropriate method from an economic and an administrative point of view. In particular, the less biased inputs principle methods of apportionment can be confined to partially exempt businesses that have a high turnover of exempt outputs and/or are specific in nature and structure, by defining, for instance, the various versions of the split quasi inputs method among the various categories of banks, the quasi inputs method for businesses with inputs for onward supply, the direct inputs attribution method for multispecialized branch companies, the indirect inputs attribution method for multibranch/multidepartment companies with pre-allocated expenditures, and so on. An optional use of the outputs principle methods for partially exempt persons under specified turnover limits of exempt outputs and/or other criteria could be designed to encompass those who prefer, for administrative convenience, to resort to the simplicity of the pro-rata rule without giving rise to any significant real or potential distortions of competition.

The partial exemption waiver rules aim at serving administrative and compliance simplification and, to this effect, the structure and broadness of their application are adjusted accordingly. In particular, these rules refer to partially exempt traders with insignificant exempt activities—that is, with negligible non-deductible input tax and/or exempt outputs relative to their business as a whole; and as a consequence, they work in a diversifying and uneven way. On this basis, the reduction of the hidden tax and its ensuing distorting effects under such rules should not be considered of any importance.

CONCLUSIONS

The VAT in the EU, under the uniform application of the sixth directive provisions, and its close counterpart in other OECD countries is of the credit type. In particular, the tax on inputs is deducted (credited) or not deducted, as long as these inputs contribute respectively to (the value of) positive-rated (including zero-rated) or exempt outputs. Assessing the deductible input tax becomes quite troublesome for businesses, which have to apportion inputs indiscriminately used for the provision of both taxable and exempt supplies (partially exempt businesses). The non-deductible input tax is incorporated in the value of exempt supplies as hidden tax, and if these supplies are at an intermediate stage of the production and distribution process, cascading effects arise across the chain.

Drawing on EU practice, this article has investigated the basic methods and rules of input tax apportionment in the case of partially exempt businesses and classified them in accordance with the fundamental principles of the sixth directive. Except for a specific version of the pro-rata apportioning application, which is statutorily provided for as a standard method in almost all VAT-applying countries of the OECD, the other methods used are, to a greater or lesser extent, the product of a consensus between national tax authorities and the traders concerned, within the discretion allowed by the sixth directive and the national legislation of non-EU countries. The article has specified the issues stemming from
the application of the apportionment techniques, examined the main differences among them, and traced the ensuing effects on domestic and cross-border activities of the EU member states, from an economic and administrative standpoint.

With the exempted supplies given in any EU member state, the deductible input tax and consequently the hidden tax in a partial exemption situation is a function of the apportionment methods used, the stage at which the exempt supplies are provided, and the likely application of waiver apportionment rules. The hidden tax in this respect distorts in principle domestic competition at any stage of production and distribution. Whether or not this is significant is a matter for further investigation. The apportionment methods applied by the businesses concerned can in effect be distinguished between those carried out by reference to either outputs or inputs. The outputs-based methods use various versions of the pro-rata rule, whereby the taxable proportion of the total value of outputs is treated as the deductible proportion of the total input tax. The inputs-based methods resort to the direct or indirect attribution of input tax, with any non-attributable residual input tax apportioned according to the pro-rata rule. The pro-rata methods are simple in their operation, but may give a biased deductible proportion of input tax either to the traders or to the authorities, and may affect their cash flow. The inputs methods are costly but more accurate, since they limit the pro-rata calculation to residual input tax. As for the waiver apportionment rules, they are confined to traders with a small non-deductible input tax and/or limited exempt outputs, and thus are expected to give rise to restricted distortions of competition in the domestic market.

On the other hand, given the differences in tax rates and incidence in the EU, the non-uniform use of the various apportionment methods by intra-EU competitors, and the differences among the member states in the determinants of the basic parameters of the widely used pro-rata methods, may affect the competitiveness of the respective cross-border transactions (through the hidden tax arising therefrom). In particular, the determinants refer to the (calculation and the application base) parameters of the pro-rata proportion (that is, disregarded supplies, valuation of certain exempt supplies like foreign exchange, commercial paper, etc., and optional taxation or allowances for exemption of otherwise exempted or taxable supplies respectively), and its application base (irrecoverable input tax). The waiver rules, which are adopted differently (if at all) by the various member states, do not appear to exert any significant effect on cross-border competition.

The analysis in this article shows that there is considerable ground for the EU to promote a more harmonized implementation of the partial exemption regime among the member states by a tighter standardization of the main determinants of the calculation and application base of the pro-rata formula and a more uniform and effective application of the less biased apportionment methods among the various classes of partially exempt businesses in the member states. In principle, this harmonization would to some extent reduce any real or potential
distorting effects on the neutrality of the tax, thus strengthening healthy competition and increasing the uniform application of the tax (which are preconditions for the completion of the single market). The analysis presented here may contribute to a more consistent use of these methods by the other VAT-applying countries of the OECD.

Notes


2 It should be noted that the Canadian goods and services tax, unlike the VAT, is a purchaser liability, not a vendor liability, tax.


4 On the basis of calculations for EU member states, approximately one-third of total consumption expenditure would be exempted or cannot properly be considered part of the VAT base: European Commission and Organisation for Economic Co-operation and Development, *Value-Added Taxes in Central and Eastern European Countries (A Comparative Survey and Evaluation)* (Paris: EC, OECD, 1998), 53.


6 The taxable amounts of the supplies include any subsidy directly linked to the price of these supplies (article 11.1.a of the sixth directive). The partially exempt businesses in the member states may also include in the denominator of the pro-rata proportion the amount of state and EU subsidies received (article 19.1 of the sixth directive).


11 See supra note 4, at 24.

12 Ibid., at 123.

13 It is assumed, as an example, that a stockbroker made the following numbers of transactions for each category of his exempt outputs in a given year: sales of securities as arbitrageur, 20; other sales of securities as principal, 10; loan transactions as principal (for example, money broker), 40; loan transactions as agent, 20; items of rents received for premises, 10. Therefore, the total number of his exempt transactions was 100. It is further assumed that, in the same year, he made 1,000 taxable transactions by buying and selling securities on behalf of clients (“bargains”) in his normal capacity. On the basis of these figures, his deductible proportion of input tax amounted to \( \frac{1000}{1100} = \frac{10}{11} \).


(2001), Vol. 49, No. 1 / nº 1
15 See supra note 10.

16 Canada Customs and Revenue Agency, Form GST10, Application or Revocation of the Authorization To File Separate GST/HST Returns and Rebate Applications for Branches or Divisions.

17 Such a method was the product of the agreement between certain major clearing banks of the British Bankers Association and the Customs and Excise in the United Kingdom in 1973. In the year of the agreement, the formula was determined to be $\frac{a}{b} = \frac{82}{18}$ subject to revision as changing circumstances necessitated. The banks concerned were nonetheless free to use this method or to negotiate other special arrangements. See British Bankers’ Association, “Value Added Tax: Partial Exemption Formula,” circular dated March 28, 1973, Arrangements with Customs and Excise (London, 1973).

18 Information provided by the respective countries.

19 See supra note 10.

20 See supra note 4, at 126.

21 See supra note 14.


24 European Commission, supra note 23, at 18.