

# **ANALYSIS OF POTENTIAL IMPACTS OF INCLUSION OF LOCALLY SUPPLIED SERVICES INTO REDUCED VAT RATE ON THE SUPPLIERS OF THESE SERVICES**

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**Abstract:** Member States of the European Union are in accordance with the Community law allowed to include locally supplied services into reduced value added tax rates (hereinafter referred to as “VAT rates”) without time restriction. In the Czech Republic there has not yet been a sufficient political will to implement this possibility into the legislation. The purpose of this paper is to analyse the potential impact of the relevant Directive implementation into the Czech VAT Act on the tax liability of the suppliers of these services. The paper is based on the comparison of the national legislation and the Community law, and their analysis. Moreover, the deductive method is used in this paper.

**Keywords:** VAT Rates, Services, Harmonization, Directive, European Union

**JEL Classification:** H25, K34

## **Introduction**

The Value Added Tax Act, No. 235/2004 Coll. (hereinafter referred to as the “VAT Act”), came into force on the day of the Czech Republic’s entry to the European Union. The provisions of this VAT Act were based on the relevant Directive, specifically the Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment.

The Sixth Directive was amended several times and on 1 January 2007 it was replaced by Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (hereinafter referred to as “VAT Directive”). The VAT Directive has been passing through further amendments and changes since its entry into force. In 2009 it was also amended by Council Directive 2009/47/EC of 5 May 2009 amending Directive 2006/112/EC as regards reduced rates of value added tax (hereinafter referred to as “Council Directive 2009/47/EC”), which entered into force on 1 June 2009.

## **Aim and methodology**

The aim of this paper is to analyse the potential impact of possible implementation of Council Directive 2009/47/EC into the Czech VAT Act, the application of a reduced VAT rate to locally supplied services. Above all, this paper analyses the impact of these legislative changes on the tax liability and the amount of free funds for taxable persons,

suppliers of these services, and the possible impact on the decisions of persons exempt from VAT application to become a voluntary taxable person.

The paper is based on the comparison of the national legislation and the Community law, and their analysis; furthermore, the deductive method is used. The author used her own data sources for calculating practical examples. These examples are based on the author's experience that she gained as an auditor in the tax administration.

### **Application of VAT Rates**

The legal framework for the application of VAT rates in Member States is included in the VAT Directive, in particular in Articles 93 to 130 and its relevant Annexes.

The basic rule for the application of VAT rates in Member States is:

- supplies of goods and services subject to VAT are normally subject to a standard rate of at least 15%;
- Member States may apply one or two reduced rates of not less than 5% to goods and services enumerated in a restricted list.<sup>1</sup>

However, most of Member States had derogations that bring inequality into the treatment of Member States.

According to the Directive, Member States could include a limited range of goods and services into the reduced VAT rates until the end of 2010.

In 2007 Copenhagen Economics carried out a study on reduced VAT rates applied to goods and services in Member States of the European Union. This study mainly examined the impact of reduced VAT rates and derogations on locally supplied services, especially in terms of job creation, economic growth and proper functioning of the internal market.

In 2008 the European Commission carried out an on-line consultation to ascertain the views of the public and businesses on the review of the existing legislation on VAT reduced rates. On the basis of these consultations quite convincing economic arguments for the application of reduced VAT rates in very particular sectors were found.<sup>2</sup>

The European Commission concluded that the application of reduced VAT rates to labour intensive services, which are intended for the local market, poses no real threat to the

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<sup>1</sup> [http://ec.europa.eu/taxation\\_customs/taxation/vat/how\\_vat\\_works/rates/index\\_en.htm](http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/rates/index_en.htm)

<sup>2</sup> [http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/gen\\_info/economic\\_analysis/tax\\_papers/taxation\\_paper\\_13\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_13_en.pdf)

proper functioning of the internal market. On the contrary, transfer of these services from the standard to the reduced VAT rates can foster economic growth, the transfer of these services from the informal economy into the legal sphere and also promote job creation.<sup>3</sup>

For these reasons the Council Directive 2009/47/EC, which authorises Member States to apply reduced VAT rates in certain sectors on a permanent basis, was adopted.

These are the services that were listed in Annex IV of the VAT Directive and after the approval of the Council Directive 2009/47/EC are inserted to Annex III:

- minor repairing of bicycles, shoes and leather goods, clothing and household linen (including mending and alteration);
- renovation and repairing of private dwellings, excluding materials which account for a significant part of the value of the service supplied;
- window-cleaning and cleaning in private households;
- domestic and care services such as home help and care of the young, elderly, sick or disabled;
- hairdressing.

Furthermore:

- restaurant and catering services (including or excluding the supply of alcoholic and non-alcoholic beverages);
- supply of books on all physical means of support.<sup>4</sup>

### **Analysis of the Current State of Czech Legislation in this Area**

Since 1 January 2010 the Czech Republic has been applying the standard rate of 20 % and the reduced rate of 10 %.

Currently, according to Annex No. 2 to the VAT Act, under the reduced VAT rate from the above mentioned services are:

- window-cleaning services carried out in households;
- traditional cleaning services performed in the interior of households;
- home care for children, elderly, sick and disabled citizens.

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<sup>3</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:116:0018:0020:EN:PDF>

<sup>4</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:347:0001:0118:en:PDF>

The application of the reduced VAT rate on house construction is defined in Section 48 of the VAT Act.

According to this section, the reduced VAT rate shall apply to a supply of building and erection works relating to an alteration of a completed residential building, house or flat, including appurtenances, as laid down in the Building Code, or relating to a repair of any such building, house or flat. If these works are carried out on another building of which a certain part is intended for dwelling, the reduced VAT rate shall apply to those works which are exclusively carried out on the part of building intended for dwelling.

However, Section 48 of the VAT Act shall cease to be in legal force on 1 January 2011.

Anyway, this provision does not affect the VAT rates on buildings for social housing, which is separately regulated in the Section 48a of the VAT Act. The reduced VAT rate on buildings for social housing can be applied permanently.

### **The First Example of the Potential Impact of Council Directive 2009/47/EC Implementation on Czech Taxpayers – Hairdressing Services**

The first example analyses a potential impact of these possible legislative changes on a small entrepreneur – a supplier of hairdressing services. Data are expressed in CZK and are counted per month.

**Fig. 1 Hairdressing services (self-employed person) – major expenditures (CZK)**

Major expenditures subject to VAT (CZK):	Taxable amount	VAT (input tax)	Price including VAT
- rental of business premises <sup>5</sup>	10,000	2,000	12,000
- electricity	1,000	200	1,200
- water (reduced VAT rate)	2,000	200	2,200
- common repairs and maintenance of premises equipment	2,000	400	2,400
- material	30,000	6,000	36,000
<b>TOTAL</b>	<b>45,000</b>	<b>8,800</b>	<b>53,800</b>

Source: *author's own source*

<sup>5</sup> lease of non-residential places to person exempt from VAT application is VAT-exempt

Other major expenditures include monthly payments on social and health insurance, which would be about 3,877 CZK per month in this calculation of revenues and expenditures. But of course, these expenditures are not subject to VAT.

Revenues of this supplier of hairdressing services are 70,000 CZK per month. If he becomes a VAT payer, these revenues will include VAT.

**Fig. 2 Hairdressing services (self-employed person) – comparison of monthly revenues according to VAT rates without changes in prices for the final consumer (CZK)**

Revenues (CZK)	Taxable amount	VAT (output tax)	Price including VAT
VAT rate 20%	58,331	11,669	70,000
VAT rate 10%	63,637	6,363	70,000

Source: *author's own source*

**Fig. 3 Hairdressing services (self-employed person) – comparison of tax liability with the reduced and the standard VAT rate (CZK)**

	VAT rate 10 %	VAT rate 20 %
Input tax	8,800	8,800
Output tax	6,363	11,669
Tax liability	- 2,437	2,869

Source: *author's own source*

The comparison in Figure 3 shows that in case of the application of the 10 % VAT rate the excess deduction arising to this tax payer is 2,437 CZK. According to the results of the calculation it is clear that in case of the reduced VAT rate applicable to hairdressing it would be advantageous for this service provider to become a voluntary taxpayer. The excess deduction of 2,437 CZK per month could help him remain on the market.

### **The Second example of the Potential Impact of Council Directive 2009/47/EC Implementation on Czech Taxpayers – Restaurant Services**

The second example analyses the potential impact of these possible legislative changes on a supplier of restaurant services. Data are expressed in CZK and are counted per month.

Figure 4 presents the main current expenses in the selected restaurant. It is supposed that the stocks which are purchased during the month are also consumed in this period.

**Fig. 4 Restaurant services – major expenditures subject to VAT (CZK)**

Major expenditures subject to VAT (CZK):	Taxable amount	VAT (input tax)	Price including VAT
- foodstuffs including non-alcoholic beverages (reduced VAT rate)	120,000	12,000	132,000
- alcoholic beverages	30,000	6,000	36,000
- tobacco products	10,000	2,000	12,000
- rental of business premises	20,000	4,000	24,000
- electricity	8,000	1,600	9,600
- water (reduced VAT rate)	3,000	300	3,300
- gas	5,000	1,000	6,000
- common repair and maintenance of premises equipment	5,000	1,000	6,000
- advertising	3,000	600	3,600
- fuels	4,000	800	4,800
- common repairs and maintenance of a vehicle	2,000	400	2,400
<b>TOTAL</b>	<b>210,000</b>	<b>29,700</b>	<b>239,700</b>

Source: *author's own source*

Other major expenditures that are not subject to tax include for example personnel costs (salaries and monthly payments on social and health insurance).

Revenues of this restaurant are about 350,000 CZK per month. These revenues therefore include VAT.

**Fig. 5 Restaurant services – monthly revenues in case of the application of the standard VAT rate (20%) to the supplies of meal including non-alcoholic beverages (CZK)**

Revenues – restaurant services (CZK)	Taxable amount	VAT (output tax)	Price including VAT
- supplies of meal including non-alcoholic beverages	232,557	46,523	279,080
- supplies of alcoholic beverages	48,000	9,600	57,600
- supplies of tobacco products	11,100	2,220	13,320
<b>TOTAL</b>	<b>291,657</b>	<b>58,343</b>	<b>350,000</b>

Source: *author's own source*

**Fig. 6 Restaurant services – monthly revenues in case of the application of the reduced VAT rate (10%) to the supplies of meal including non-alcoholic beverages, the rest of services shall apply the standard VAT rate (CZK)**

Revenues – restaurant services (CZK)	Taxable amount	VAT (output tax)	Price including VAT
- supplies of meal including non-alcoholic beverages (10% VAT rate)	253,712	25,368	279,080
- supplies of alcoholic beverages	48,000	9,600	57,600
- supplies of tobacco products	11,100	2,220	13,320
<b>TOTAL</b>	<b>312,812</b>	<b>37,188</b>	<b>350,000</b>

Source: *author's own source*

**Fig. 7 Restaurant services – comparison of the tax liability according to VAT rates applied to restaurant services including the supply of non-alcoholic beverages, the rest of these services shall apply standard VAT rate (CZK)**

	VAT rate 10 %	VAT rate 20 %
Input tax	29,700	29,700
Output tax	37,188	58,343
<b>Tax liability</b>	<b>7,488</b>	<b>28,643</b>

Source: *author's own source*

The comparison in Figure 7 shows that the application of the 10 %VAT rate to restaurant services including the supply of non-alcoholic beverages reduces the tax liability of the tax payer by 21,155 CZK per month without changes in prices for the final consumer. The

supplier of restaurant services could use the difference between the tax liabilities for example for personal costs of his employees.

### **Conclusion**

With respect to Council Directive 2009/47/EC, an amendment to the VAT Act, which would implement the provisions of this Directive with effect from 1 January 2010, was prepared. But finally, this amendment did not find sufficient political support for approval.

One of the reasons for disapproval of this amendment was that it would cause an increase in public budgetary shortfall for 2010 by approximately 4–5 billion CZK. Another serious argument against the approval was that the effect of this tax relief is not measurable.

There are still politicians' efforts to take advantage of this Directive at least partially and allow the application of the reduced VAT rate on house construction, which is defined in Section 48 of the VAT Act without time restriction. This change was last proposed through Parliamentary Document No. 959, which was not approved by the Senate in May 2010.

The result of this paper is the ascertainment that the transfer of these services from the standard to the reduced VAT rate for Czech taxpayers would cause a considerable reduction of their tax liability. Although the service suppliers are not supposed to lower the prices of their services largely in case of the implementation of this Directive, the remaining funds could be used for the development of their business or for labour costs. Consequently, the government would save financial resources used on unemployment and social benefits. A lot of companies that are not taxpayers would begin to consider their registration for VAT and this situation would also influence their decisions when selecting suppliers of their inputs as they would probably choose a VAT payer. Furthermore, it is very likely that there would be changes in lease agreements, the exempted transactions without entitlement to VAT deduction would be transferred to taxable transactions (with entitlement to VAT deduction).

Unfortunately, the most unpleasant situation is in restaurant and catering services, where most of the inputs are subject to the reduced tax rate and all outputs are still subject to the standard VAT rate.

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