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Value Added Tax and Direct Taxation

Similarities and Differences

IBFD

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VAT/GST and Direct Taxes: How can We Distinguish Them?[1]

Paolo de'Capitani di Vimercate

I. Brief historical overview: Absence of a continuous evolution toward direct or indirect taxation

While the common saying is that direct taxes are an evolution of the tax system, the literature has shown that this is an oversimplification that can be held valid only if we examine exclusively the tax systems that have been implemented during the last centuries in Europe.[2]

Indeed, while indirect taxation was in its heyday during the 17th and 18th centuries, European countries started to increasingly put their reliance for revenue on direct taxes during the nineteenth and twentieth centuries, when the social, administrative and economic conditions allowed them to do so and governments started to chase after further policy objectives through the tax system.

While it is true that Athenians and Romans partly relied on indirect taxation, African, Asian and Mid-Eastern civilizations (apart from exceptional and occasional revenue derived by means of conquest and plunder) relied heavily on direct taxes such as periodic levies in the form of slaves, gold dust, maidens, annual (gross produce) tithes from the subjugated, taxes on flocks, poll taxes, artisan taxes and taxes on foreign residents (for example, the metics in Athens). The aversion of the free citizens of Rome and Athens to direct taxation does not mean that no direct tax was levied in those systems. In fact, direct taxes were imposed on resident foreigners (especially those involved in trade) and subjected people; the ruling class often excluded itself from direct taxation, be it Rome, Athens or Persia, and lived off the direct taxes imposed on others. Quite to the contrary of the current feeling, given the difficulty of imposing and actually collecting direct taxes, a push toward more indirect taxation was often based on equity

1. This paper is dedicated to the memory of Professor Oliver Oldman.
2. Hinrichs, *A General Theory of Tax Structure Change During Economic Development* (1966) pp. 87 and et seq.

reasons,[3] as privileged classes often secured for themselves immunity from direct taxation.

In total, however, direct taxes accounted for most of the public revenues in these civilizations.[4]

The observation of recent trends in tax policy, on the other hand, seems to permit the conclusion that no predetermined march of progress in taxation can be envisaged based on the distinction between direct and indirect taxes. We can observe, in fact, that after a greater reliance on direct taxes in the mid-twentieth century,[5] European countries have moved toward an increase of indirect taxation, in particular after the introduction of the common system of VAT. Recent trends, most likely caused by the pressure of globalization and international tax competition, are toward a further increase of indirect taxation through VAT at the expense of the income tax.[6] Think of the recent reforms in Germany, where in light of the pressure on the tax system coming from neighbouring Eastern European countries the rate of VAT was raised from 16 to 19% and the corporate tax rate cut down to 25%;[7] or the proposal of President Sarkozy in France to raise the VAT rate to 25% in order to finance a cut in social security contributions.

II. The discussion regarding the superiority of specific levies (direct v. indirect taxes)

The literature has also long discussed the superiority of direct taxes over indirect taxes from the point of view of economics. If we (imprecisely, though, as stated below) consider the income tax as the representative of

3. Seligman, *Essays in Taxation*, 10th Ed. (1925) p. 5, quoted by Hinrichs, cit., p. 89 together with Fournier de Flaix, *L'Impôt dans les Diverses Civilisations* (1897) (Vol. I for Oriental civilizations, Vol. II. for ancient Greece, Vol. III for Rome and Vol. IV for feudal France.

4. Augustus even imposed an inheritance tax (*Vicesima Hereditatum*); Hinrichs, cit., p. 91.

5. For a picture of the tax systems in the early twentieth century see Seligman, *Essais sur l'impôt*, Tome second, 8ème ed., Trad. française (1914), ch. 14.

6. Lee, *Indirect Taxes Paying for Global Corporate Tax Competition*, www.tax-news.com/archive/story/, 28 June 2007.

7. Overesh-Wamser, *The Effects of company Taxation in the EU Accession Countries on German Multinationals*, March 2008; Fuest, *Financing Social Insurance Contribution Rate Cuts via Higher Value Added Taxes – the German Experience*, November 2007; Rădulescu-Stimmelmayr, *Die Unternehmensteuerreform 2008: Eine Reformalternative für Deutschland?*, in *Perspektiven der Wirtschaftspolitik*, 2008 9(1): 19–36.

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direct taxes and the consumption-type VAT or the Retail Sales Tax (RST) as the representative of indirect taxes, we could quote Hobbes and his Leviathan, in which he supported the use of taxes on consumption rather than income taxes, based on the fact that people should be penalized for the resources they withdraw from society, rather than for the wealth they create, given that consumers and workers enjoy the same public services provided by the state. Such a view, however, does not account for consumption of goods and services that are not limited and can be re-consumed infinitely and in any case has never been greatly appreciated by governments around the world.

More recently and during the twentieth century, the discussion has focused on the alleged superiority of direct taxes over indirect taxes[8] and, especially after the introduction of the EU VAT, vice versa.[9] For example, it has been demonstrated that progressive income taxes affect the supply of labour, as every additional hour of work and the additional gross salary thereby earned is less valuable after tax and therefore the incentive to work is decreased by increasing marginal rates (income effect).[10] On the other hand, income taxes also induce a substitution effect, because the difference between gross and net income they introduce may push the worker to supply more labour at the expense of leisure. Outlay taxes, on their side, also have a different impact on the economy depending on their features; for example, depending on whether they are general or specific and on whether they are ad valorem or based on the quantity of goods/services sold/supplied, and, of course, depending on the elasticity of the demand and supply curve.[11] Such effects of taxation are not always to be avoided, and, on the contrary, they may constitute an important tool of public finance (for example, in cases of not fully competitive markets, or in case an increase in the supply of labor is sought).

8. Joseph, *The Excess Burden of Indirect Taxation*, Review of Economic Studies, Vol. VI, n. 3; Hicks, Value and Capital (1939) p. 41, quoted by Walker, cit., footnote 7.
9. See Walker, *The Direct – Indirect Tax Problem: Fifteen Years of Controversy*, 10 Public Finance, 153 (1955); *The Role of Direct and Indirect Taxes in the Federal Reserve System*, UMI, 1964, A conference report by the National Bureau of Economic Research and the Brookings Institution, Princeton University Press, 1964.
10. An issue confronted with by the flat tax of Hall and Rabushka: *Low Tax, Simple Tax, Flat Tax*, New York 1983 and *The Flat Tax*, Stanford, 2nd Ed. (1995), by which progressivity of the income tax (though to a lesser extent) is maintained even with a uniform marginal rate by way of an initial deduction.
11. From the point of view of optimal taxation, a general *ad valorem* tax is considered to be equivalent to a poll tax, and thereby is preferred to an income tax; see Walker, cit. 163.

In conclusion, it appears that no final statement on superiority can be drawn with respect to direct and indirect taxes, each of them having its merits and side effects.

In the words of a father of the subject, we could say that "*There is nothing inherently bad about an indirect tax, nor is there anything good about a direct tax. It depends entirely about what kind of direct or indirect tax it is. A direct tax on the laborer is not necessarily good because it is direct; an indirect tax on the luxury of the rich is not necessarily bad because it is indirect [...] it is by no means impossible to frame a system of taxes on consumption which will supplement other taxes and do substantial justice to all*".[12]

On the other hand, while collecting the greater part of the public revenue through direct taxes was believed to be silly, given the low state of public morality of contributors,[13] experience has shown that the collection of revenue through indirect taxes is not at all immune to fraud and evasion[14].

III. Tax equivalencies

The literature has made clear that brands can be misleading with regard to distinguishing single taxes. In fact, (almost) the same tax base can be hit in various ways, and thus through taxes that go under different names.[15] The most common example is given by illustrating the Haig-Simons formula for describing the taxable base of the income tax as Y=C+I, or W+R=C+I (where W stands for labour income and R for capital income). This very formula, however, can be used to illustrate the taxable base of a value added tax of the income type. Following this example, the VAT taxes consumption, which in the formula would be C=Y−I. This base could be taxed, in addition to the traditional EU VAT or a retail sales tax, by way of a Kaldorian direct tax, where investment is fully and currently deducted from the taxable base.

12. Seligman, *Essays in Taxation*, 10th Ed., pp. 9–10, n. 2, recalled by Hinrichs, *A General Theory of Tax Structure Change During Economic Development*, p. 112.
13. John Stuart Mill, *Principles of Political Economy* (1892) pp. 522–523, quoted by Hinrichs, cit, p. 117.
14. The most evident example being carousel fraud in the European VAT.
15. In the Italian literature, see for example Leccisotti, *Economia dei tributi* (2007) pp. 11–16.

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That said, however, the devil is in the detail; this is to say that levying a tax on consumption, or for that matter on income, in one way rather than another can lead to significant differences, not only for a single taxpayer, but also for the whole tax system.

Tax law drafting is thus very important in making the above-recalled equivalencies hold or, on the contrary, become almost meaningless[16]. To give an obvious example of such a conclusion, one may think of the EU VAT, in which the zero rating of exports and taxation of imports are used to implement the destination principle, according to which consumption is not only the taxable base, but also the criterion for distributing revenue from cross-border transactions. While changing the taxation of cross-border supplies would leave the tax base unchanged, it would bring about a major change in the functioning of the levy. A Kaldorian direct consumption tax, unlike the EU VAT, would be based on the origin principle and would most likely be regarded, apart from the issue of the shifting of the tax burden, as a tax on producers, whereas the EU VAT is considered to be a tax (indirectly levied) on consumers. Specific features of any single tax can thus turn out to be even more important than what is affirmed to be the taxable base of the tax itself in (sometimes simplistic) economic terms. American firms that historically have complained about the rebate of exports granted to EU exporters under the common system of VAT already know a bit about this.

IV. The distinction between direct and indirect taxes

According to John Stuart Mill, the distinction between direct and indirect taxes is based upon the ultimate incidence of the tax burden. In other words, if a tax is levied upon a taxpayer who subsequently shifts the burden of the tax onto another subject, then we should consider this tax as an indirect tax. The distinction should then be based on "*whether the person who actually pays the money over to the tax collecting authority suffers a corresponding reduction in his income. If he does, then – in the traditional language – impact and incidence are on the same person and the tax is direct; if not and the burden is shifted and the real income of someone else is affected (i.e. impact and incidence are on different people) then the tax is indirect*".[17]

16. This view is shared by Neumark, cit., p. 292.
17. J.S. Mill, *Principles of Political Economy*, Book V, Ch. III, quoted by Shenk-Oldman, *Value Added Tax. A Comparative Approach* (2006) p. 5.

Such a distinction, however, has been increasingly criticized as economists have proved that tax shifting is uncertain and variable depending on the elasticity of the demand and the supply curves; it can be partial and it is difficult to assess for all kind of taxes.[18]

Compared to the past, economists thus tend to mitigate the importance of the distinction between direct and indirect taxes. I share their view and would rather focus more on the reasons for drawing a distinction between one tax and another in various contexts.

Far from being irrelevant, however, such a distinction has material legal consequences for countries belonging to institutions like the World Trade Organization and the European Union, as the respective provisions concern indirect taxes more than direct taxes (on which the impact of such provisions is quite… indirect!). This could be explained by the fact that at the initial stage of the integration process of international markets, be they worldwide markets or European markets, such integration can be secured by removing the most evident obstacles to international trade in goods and services. Indirect taxes, which directly and manifestly affect such trade, are thus the first barrier that must be eliminated on the path toward integration.

Obviously, this does not mean that direct taxes as such do not affect international trade. In fact, we can learn much about their impact on international flows of goods and services from the WTO cases on direct taxation (e.g., DISC, FSC, ETI) and, even more, from the jurisprudence of the ECJ on direct tax matters.[19]

18. Seligman, *Essais sur l'impôt*, cit., p. 13; more recently, Thuronyi, *Comparative Tax Law* (2003), pp. 54–55; Shenk-Oldman, cit., p. 5. An interesting case arose after the introduction in Italy of the "Robin Hood Tax", which consists in a higher corporate income tax rate applied to oil and gas and energy companies. Leaving aside the *ratio* of such discrimination and the doubts regarding its constitutionality, we should note that in order to prevent these companies from shifting the burden of the increase onto consumers, Art. 81.18 of the Law Decree 112/2008 has introduced a legal prohibition of shifting such burden onto consumers. Such a prohibition obviously requires adequate controls, but the latter seem to be quite arguable and add even more intricacies to such a complicated matter. See: Marongiu, Robin Hood Tax: taxation without "constitutional principles", in *Rass. Trib.*, 2008, 1335; Bellinazzo, *Sulla Robin tax il Tar Lombardia blocca l'Authority*, in *Il Sole24Ore*, 7 February 2009.

19. Gammie, The Role of the European Court of Justice in the Development of Direct Taxation in the European Union, *Bulletin for International Fiscal Documentation* 2003, p. 86.

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Given the difficulty of drawing a clear-cut general distinction between direct and indirect taxes, many authors simply enumerate what they deem to be direct taxes on the one hand and indirect taxes on the other.

Following this lead, the Agreement on Subsidies and Countervailing Measures, Annex I, Footnote 58 of the WTO defines direct taxes as "*taxes on wages, profits, interest, rents, royalties, and all other forms of income, and taxes on the ownership of real property*" and indirect taxes as "*sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges*". Under WTO rules, according to the view that sales taxes like the VAT are ultimately borne by consumers whereas income taxes are borne by producers (owners, shareholders, workers),[20] border tax adjustment for indirect taxes – such as the EU VAT, to the dissatisfaction of US firms – are not considered a subsidy, while similar adjustments in the field of direct taxation are not allowed.[21] In some countries the distinction bears importance for tax assignment issues among national and subnational administrations.[22] In the US, for instance, direct taxes must be apportioned among the states according to their population[23].

A second criterion for distinguishing between direct and indirect taxes has been indicated in the index of ability to pay that is chosen as a tax base. The choice of the parameter for applying this criterion is clearly discretional, but convention in the literature is that it should be income or wealth. Thus, irrespective of the taxpayer that is legally bound to face the levy and irrespective of the phenomena of shifting of the burden, a tax is usually considered to be direct if it directly impinges on income or wealth, while it is considered an indirect tax if it impinges on income or wealth only indirectly. Under this method, consumption taxes, whether transaction based or based on the accounts of the firm, are always indirect, because consumption is considered to be only an indirect index of the ability to pay[24].

20. Shenk-Oldman, cit., p. 18, footnote 63.
21. See the cases on the DISC, FSC and ETI provisions of the US income tax.
22. Shenk-Oldman, cit., pp. 5 et seq.
23. Art. 1, Sec. 2, Clause 3 and Sec. 9, Clause 4 of the US Constitution.
24. The discussion in the first section of this book concentrated on the different index of ability to pay that is the basis of the income tax and of the VAT. In fact, most authors argued that the VAT is in breach of the ability to pay principle, at least when vertical equity is considered. In this respect it is useful to recall that in economic terms the EU VAT, as a tax on consumption, could be regarded as a tax on labour income. And while such income is already heavily taxed in most countries and the budget constraints call for the collection of additional revenue, consumption taxes proved to be the best alternative to collect revenue without taxing capital income, which is mobile, and also without

Under a third criterion, drawn from the analysis of the GATT (Arts. 1 and 3) and the Treaty of Rome (Arts. 90, 92 and 93), we could say that while direct taxes are imposed on the taxpayer, indirect taxes are *more directly* (!) levied upon products.

In conclusion, we can state that while the literature has not yet found a final and clear cut criterion for drawing the distinction between direct and indirect taxes, there are taxes that by definition and under any criterion have always been considered direct levies, such as the income tax and wealth taxes, and other taxes that have always been considered indirect under all the distinguishing criteria we have recalled above. In between, we can find taxes that are hardly to be included under either group.

V. VAT and VATs – The case of the Italian IRAP: Is it a direct or an indirect tax?

It is debatable, for instance, whether the IRAP (a value added tax of the income type calculated by the subtraction method) can be considered a direct or an indirect tax, an issue that this levy shares with the German *Gewerbesteuer*.[25]

In 2001 three years after its introduction in Italy, the IRAP was claimed to be a breach of the ability to pay principle before the Italian Constitutional Court. Among other arguments[26], the suit was based on the fact that the tax also hits the taxpayer on his/her costs, such as interest expense and labour, and not only on his/her income. This was considered by most Italian authors as unconstitutional.

With reference to the distinction between direct and indirect taxes, we could note that in order to spare the tax from the alleged breach of the constitutional principle of the ability to pay enshrined in Art. 53 of the Italian Constitution, the Italian Constitutional Court held that the tax is in line with such a constitutional principle, because it can be shifted onto consumers,

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further raising the nominal rates on labour income, which are already considered too high. Zee H., World Trends in Tax Policy: An Economic Perspective, *Intertax* 2004, pp. 357–358.

25. Neumark, cit., p. 289.

26. Such as the fact that professionals were included among the taxpayers beside entrepreneurs, thereby interrupting a traditional favourable treatment of income from labor compared to income from capital (qualitative discrimination of different kinds of income).

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workers and lenders.[27] Indeed, given the prominent social position of entrepreneurs (and professionals) and their capacity to organize the factors of production and to shift the burden of the tax, the levy must be considered as indirectly borne by these other constituents, so that there is no breach of the ability-to-pay principle.

However rough this reasoning may seem to an economist and however poor it may seem to a lawyer, there is no appeal against the decision of the Constitutional Court and, apart from always promised but up to now never introduced reforms by the Italian parliament, the IRAP is here to stay in the Italian tax system.

Apart from the official constitutional justification of the levy, and bearing in mind the material importance of the revenue stream that flows to the Italian Regions and thereby to the health care system thanks to the IRAP, most of the literature[28] considers the IRAP and value added taxes of the income type calculated by the subtraction or by the addition method as direct taxes.

Indeed, under the criterion illustrated by John Stuart Mill, such taxes are imposed directly on the taxpayer and immediately reduce his/her income. In fact, unlike other outlay taxes such as some excises or the EU VAT, there is no legal right/obligation of redress for the taxpayer on his/her clients and the shifting of the tax burden, as for any other levy, inclusive of the income tax, is left to market forces.

In this respect, with regard to addition and subtraction-method VATs, I would leave apart the criterion based on the taxable base on which the levy is imposed. This is because, frankly speaking, I am not sure whether value added can be considered direct or, perhaps more likely, an indirect index of ability to pay.

For our purposes, however, we shall consider the IRAP a direct tax, given that it bears more important similarities to an income tax rather than to the EU VAT (see below) and that also based on the third criterion above, the IRAP is not strictly connected to the products or services supplied.

27. Italian Constitutional Court, decision of 21 May 2001, No. 156.
28. See for example Procopio, L'asserita incompatibilità dell'IRAP con la normative comunitaria, *Dir. prat. trib.* 2005, I, 632 and 634; Bosi-Guerra, *I tributi nell'economia italiana*, II ed. (2001) p. 230 who in any case express some doubts regarding the characterization of the tax as direct/indirect.

A confirmation of such a statement is found in para. 30 of the decision of the ECJ in the case C-475/03, discussed below, where the court affirms that "*It [the IRAP] includes elements such as the variation in stocks, amortization and depreciation, which have no direct connection with the supply of goods or services as such*"[29]. In addition, from a legal standpoint, the IRAP is governed by the same rules provided for the income tax under various aspects, such as for the assessment, and it can be credited under most of the tax treaties concluded by Italy for the avoidance of double taxation on income.

5.a. The distinction between VAT and a direct tax in practice: the decision of the ECJ on the compatibility of the Italian IRAP with Art. 33 of the Sixth Directive

With the caveats recalled above and on the basis of the similarities with the income tax we shall describe below, we can thus consider the Italian IRAP a direct tax.

In this respect, we can analyse the case that was brought before the ECJ with regard to the Italian IRAP and its alleged incompatibility with EC law under Art. 33 of the Sixth Directive.

In fact, some Italian authors had argued that the Italian IRAP was too similar to the EU VAT to be in line with Art. 33. An Italian bank had raised the issue before a local tax court, which decided to refer the case to the ECJ.

The conclusions of Advocate General Jacobs were against the Italian tax and this threw the Italian government into despair.[30] Most commentators saw the case as already lost and gave up the tax for dead. No one, however, were able to indicate how to replace the revenue annually raised by the IRAP to the benefit of the Italian Regions. With the support and encouragement of Professors Oldman and Uckmar, a brief *amicus curiae* was even sent to the President of the ECJ, in order to advocate the compatibility of the tax, which although manifest, had been overlooked by the Advocate General.[31]

29. ECJ, 3 October 2006, C-475/03, *Banca popolare di Cremona*. See also the excerpt from *Careda* reported at footnote 41 below.
30. See, for example, the report by Professor De Mita, *Ma l'IRAP è senza eredi*, in *Dir. prat. trib.*, 2005, I, 767.
31. Oldman-Cnossen-Bird-de'Capitani, Letter to the President of the European Court of Justice Concerning the Italian IRAP and the European VAT, in *Diritto e pratica tributaria internazionale* 2005, p. 358 (in English) and *Diritto e pratica tributaria*, 2005, I, 777 (in Italian).

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The case was then reopened and a second Advocate General (Stixs-Hackl) was appointed, with the duty to deliver new conclusions. This time, the conclusions, although not entirely in favour of compatibility under Art. 33, left the case open and suggested leaving the final decision to the national courts.[32]

For the sake of distinguishing between the EU VAT and a direct tax, we can recall some of the arguments that were used before the ECJ for illustrating the difference of the Italian IRAP and the EU VAT.[33]

The main features of the Sixth Directive's VAT, which is designed to implement the harmonization requirement of Art. 93 of the Treaty of Rome, as revised by the Treaty of Maastricht, are:

(1) The basis for the VAT is to tax the personal consumption which constitutes both (a) the base or subject of the tax and (b) the formula for distributing the tax revenue among the Member States and for distributing the burden of the tax among consumers.

(2) The credit-invoice method of administration of the VAT tracks purchase and sale transactions and provides the information needed to calculate and verify each taxable subject's tax liabilities. VAT paid on inputs by the entrepreneur can be recovered through deductions. The credit invoice method embodies the principles of proportionality and generality by applying to prices of all transactions of all taxable subjects.

(3) The destination principle, which applies the tax to imports and removes the tax from exports, implements the system for directing the tax revenues to the country of consumption.

In particular, with regard to the VAT, the case law of the ECJ[34] has underscored that the main characters of the tax are that it is:
(1) general;
(2) levied proportionally to the price of the goods/services;
(3) levied at each stage of the production and distribution process; and
(4) ultimately borne by the consumer and is neutral as regards the taxable persons.

32. See, for example, de'Capitani, *La questione dell'IRAP torna al mittente*, in *ItaliaOggi* 16 March 2006.
33. For a comprehensive analysis regarding the distinction between IRAP and VAT under Art. 33, see Oldman-Cnossen-Bird-de'Capitani, cit., from which the following is drawn.
34. See par. 28 of the decision on the IRAP case, C-475/03, cit.

In contrast, the main features of the IRAP are:

(1) The base of the tax is the net production of income or output in an Italian Region;

(2) The tax revenue accrues to the region of production whether or not consumption takes place there;

(3) An accounts-based system is used to administer and track taxable purchases, inventories, depreciation, wages, and profits in order to determine each taxpayer's net production, or value added. The tax due may then be determined and paid;

(4) The origin principle, applying the tax to exports, but not to imports, secures the tax revenue to the Regions where production occurs, regardless of where consumption takes place.

While both taxes are levied on "value added", the Sixth Directive and the IRAP each use a different value-adding technique for determining the tax base. Each tax differs from the other in principle, in objective, and in operation.

The literature[35] has enumerated the differences between an indirect tax as the EU VAT and a direct tax as the IRAP as follows. It is important to underscore that most of the following differences not only derive from the difference in the taxable base, but also from the method by which the tax is levied.

(1) The Italian IRAP is calculated by the subtraction method, using the accounts that the taxpayers already have to keep for civil law and income tax purposes and is represented by the difference between gross receipts and the deductible costs. Basically, the tax base consists of the sum of the profits of the firm, interest expense and wages.

The profits are calculated taking into account the changes in inventory over the taxable year, rent expenses and depreciation of both tangibles and intangibles. On the other hand, investment income such as dividends, interest received and capital gains and losses are not taken into account. Because the IRAP is not a transaction-based tax, the taxpayer has neither the right nor the obligation to charge the tax with the price. Thus, there is no statutory pressure to assure that the IRAP is borne by the consumers, as there is under the VAT. The actual incidence of the IRAP will be dependent on varying market conditions. This feature was considered conclusive in a precedent of the

35. Oldman-Cnossen-Bird-de'Capitani, cit.

ECJ for denying the incompatibility of an Austrian regional tax with Art. 33 of the Sixth Directive, because such a tax cannot be considered a tax which applies proportionally to the price of the goods and services (ECJ, June 8 1999, C-338/97, *Pelzl and others*, in ECR 1999, I. 3319).

(2) From a financial point of view, the IRAP must be paid only at the end of the year. This means that while the taxpayer has to pay the tax embedded in the price of his overheads, he can try to shift it onto the customers when he resells his products and pay the tax only months later. Further, under the IRAP there are not serious problems with the refunds, as there are under the VAT. In Italy some enterprises have to wait for months for refunds. All these differences basically relate to the difference in the fundamental principles underlying the two taxes: while the VAT is a transaction-based tax on consumption and is connected to the actual purchase of goods or services, the IRAP is a tax on production that needs to be calculated on the basis of the accounts of the taxpayer, regardless of the actual purchase of goods and services by the taxpayer. A further consequence of the different way of calculating the taxable base in the VAT (on the basis of each transaction) and in the IRAP (on the basis of yearly accounts) is that under the IRAP (unlike the VAT) it is not possible to assess the exact amount of tax embedded in the retail price paid by the consumers. This also leads to the conclusion that the IRAP is not a proportional tax and thus it is not incompatible with Art. 33. This was the holding of the ECJ in the above-mentioned case C-338/97, *Pelzl and others*, where the court held that "since the charges [...] are calculated [...] on the basis of an overall annual turnover, it is not possible to determine the precise amount of the charge passed on to the customer when each sale is effected or each service supplied, and the condition that this amount should be *proportional* to the price charged by the taxable person is not satisfied either". Indeed, it is possible that in some economic sectors the price of the same good or service will vary over the year depending on market peaks (e.g. in the business of tourism or other seasonal activities), so that a customer purchasing the goods in February could actually pay a price with no embedded IRAP at all, while a customer purchasing the same item in September could pay a much higher amount which will be partly used by the seller to pay the IRAP.

(3) Under the VAT it is administratively less complicated to apply reduced rates and exemptions on certain goods and services while under the

IRAP this would imply a separate accounting for each of the favoured items and the exclusion of exempt goods.

(4) With the only side effect of some cross-border shopping by consumers close to the borders of low-VAT-rate countries, rates of tax under the European VAT are usually high (Italy's is 20%) because the applicable destination principle effectively prevents competition for cross-border trade by the zero rating of exports. The opposite is true of the IRAP, which requires the inclusion of exports in the taxable output accounts. Therefore, the rates of tax for IRAP lead to competitive pressure among the Italian regions to keep the rate low. The rate of the IRAP, recently reduced to 3.9%, reflects the competitive pressure to keep the rate low. Also, while a tax like the VAT applied on imports constitutes a proportion of the price of the goods and services consumed in the country, the same is not true for an origin-based tax like the IRAP.

(5) Under the IRAP banking and insurance services are not exempt as they are under the VAT; in this respect we should stress that the financial sector accounts on average for 25% of the GDP in OECD countries. Also, non-commercial organizations are subject to the IRAP but not the VAT.

(6) The IRAP is a not a consumption-type VAT but rather an income-type VAT. Indeed, under the IRAP capital expenditures receive the same treatment as under the income tax; thus, they can be depreciated over their lifetime. In contrast, under the VAT the cost of capital expenditures is immediately deducted. In terms of national income accounts, the economic base of the VAT is personal consumption. For the IRAP the economic base is the net national income. This means that the IRAP is a tax completely equivalent, in macroeconomic terms, to the income tax: the IRAP taxes the enterprise for the income earned by workers, by the lenders or by the enterprise itself, with the only difference that unlike the income tax, which is collected on each of these taxpayers, the IRAP is collected at source from the enterprise.

(7) Increases in inventory from year to year constitute part of the taxable production under the IRAP. Under the VAT, the input tax credits for inventory accumulation prevent inventory from becoming part of the tax base until sold. Further, the credit method allows VAT payers to carry over their losses to subsequent taxable years, while such carry over is not allowed for IRAP purposes.

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(8) The tax rates of the IRAP can be independently modified by the Regions. This feature of the tax has allowed Italian Regions to extensively maneuver with the tax rates: just for the sake of giving an example, Lombardia has applied a reduced rate to tour operators and travel agencies, exempted non-profit organizations and applied an increased rate for banks and insurance companies; Piemonte exempted the agency for the organization of the Olympic winter games; Toscana applies a reduced rate to start-up businesses and to businesses opened up by younger entrepreneurs and Abruzzo has reduced the rate applicable to drugstores.

(9) The VAT focuses attention on consumption as a reflection of ability to pay with a view towards providing revenue for all national government functions. The IRAP focuses attention on production as a reflection of ability to pay with a view towards providing revenue for local government functions related to servicing business activities. Each uses a different value added method for identifying the tax due. Each has its own purposes, tax collection and computation techniques, and sphere of use in financing governmental expenditures. These differences distinguish the case regarding the IRAP from C-200/90, *Dansk Denkavit*, where the two taxes were similar, with the only difference from the VAT being that the Danish tax was not to be reported on the invoices.

(10) While the VAT is a *general* tax, meaning that it applies equally to every kind of transaction entered into by a VAT payer, the IRAP is calculated and administered in different ways depending on the nature of the taxpayer (e.g. banks or non-profit organizations pay the tax on a taxable base different from the taxable base for industrial enterprises) and therefore cannot be considered a *general* tax like the VAT.

(11) While, as mentioned above and apart from the case of exemption on intermediate goods, the VAT is neutral as regards taxable persons, under the IRAP differences in rates from one Region to another may induce minor cascading effects.[36]

(12) From a legal standpoint, IRAP, like the Italian income tax, is not directly subject to certain EC principles, such as the principle against

36. Keen, Tax Reform in Italy, in *Tax Notes International* 2003, p. 679.

avoidance practices that guided the ECJ in the VAT cases *Halifax* and others.[37]

(13) A further undeniable statement is that a transaction-based VAT cannot be suited to and tailored on the situation of any single individual as can the income tax, which can account for particular features and characteristics of every single taxpayer. Based on this observation, the income tax is often advocated as a better tool for pursuing equity in comparison to the indirect taxes, the VAT being the most important one of this group.[38] Other prominent authors, however, note that equity can also be pursued through expenditure policies. In fact, while if analysed on a stand-alone basis the VAT is quite a regressive tax, its effect once we also take into account the use that one can make of its revenue can be surprisingly progressive, provided that most of the revenue is used to support the poor.[39]

(14) Also, notwithstanding theoretical studies advocating it to implement a federal system of VAT at (a wider) EC level, this tax is not suited for smaller federal countries where distances among subnational regions are limited. In fact, implementing a VIVAT, for example, while would solve some of the problems suffered by the current EU VAT, would create incentives for cross-jurisdictional shopping by consumers. In addition, based on the reasoning of the ECJ, an additional surcharge

37. ECJ, 21 February 2996, *Halifax and others*, C-255/02; the Italian Supreme Court (tax chamber) had referred (orders of 24 May 2006, Nos. 12301 and 12302) to the unified chambers of the same Supreme Court the question whether income tax avoidance could be countered by way of a general principle against tax avoidance derived from EC law, rather than by specific clauses (which could not be applied to the case at hand). In particular, the issue concerned the possibility to extend to the direct taxes not specifically regulated by EC law as opposed to the VAT the principles handed down by the ECJ in the *Halifax* case law. In line with the same ECJ, which had already underscored that income tax avoidance is something for the Member States to regulate and prevent (see ECJ 5 July 2007, C-321/05, *Kofoed*) the unified chambers of the Italian Supreme Court, with quite an arguable decision – especially for Italian law purposes that we cannot investigate here - held that in the context of direct taxes such a general principle cannot be drawn from EC case law (but rather from the Italian constitutional principle of ability to pay).

38. See in this regard the IMF's Fiscal Affairs Department Paper, *Should Equity be a Goal of Economic Policy?*, 35 Financial Development #3, Sept. 1998, p. 4.

39. Neumark, Comment to the Report of Eckstein and Tanzi, *Comparison of European and United States Tax Structures and Growth Implications*, presented at the conference *The Role of Direct and Indirect Taxes in the Federal Reserve System*, UMI, 1964, A conference report by the National Bureau of Economic Research and the Brookings Institution, Princeton University Press, 1964, p. 287; Galbraith, *The Affluent Society* 238, 4th Edition (1984), quoted by Shenk-Oldman, cit., p. 9.

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of the VAT meant to finance subnational governments seems to be in conflict with Art. 33 of the Sixth Directive (now Art. 401 of the recast Directive 112/2006/EC).[40]

All the described features of the IRAP make it more similar to an income tax rather than to the VAT;[41] as an example, both the IRAP and the income tax are collected on an origin and not on a destination basis so that they both tax exports and not imports; they both tax the normal rate of return of capital, while the VAT only taxes infra-marginal profits; they are both calculated on the accounts of the taxpayer and not on a transaction basis; they both tax increases in inventory, while such increases are irrelevant for VAT purposes.

And indeed, the ECJ shared this view as well and made a clear distinction between the IRAP and the EU VAT, in particular by recalling the absence, in the former, of any right to charge the tax upon the consumer. In fact, this is an important characteristic of the VAT from the point of view of the Treaty of Rome (as well as under GATT rules), if we recall that under Arts. 92 and 93 indirect taxes are those directly related to the supply of goods/services, so that taxes imposed on persons do not immediately fall within the competence of the EC under Arts. 92 and 93.[42]

40. Advocate General Stixs-Hackl, on the contrary, argued that if a tax is completely equivalent to the VAT, it can in fact be seen as a simple increase of the VAT rate and therefore it should not be considered as interfering with the functioning of the latter under Art. 33 of the Sixth Directive; see point 36 of her Opinion of 14 March 2006, C-475/03, de'Capitani di Vimercate, Iva e IRAP: due tributi di segno opposto, in *Dir. prat. trib.* 2006, II, 1302. The possibility of introducing a surcharge to the VAT in the form of a retail sales tax was studied by the Ministerial Commission led by Prof. Gallo that suggested the implementation of the IRAP. Even then, however, such a retail sales tax was believed to be in contrast with the case law of the ECJ under Art. 33 of the Sixth Directive; see Gallo, *Ratio e struttura dell'IRAP*, in *Rass., trib.*, 1998, I, 627; Commissione Gallo (1997), Studi preparatori, La nuova imposta regionale sulle attività produttive, in *Quaderni del Ministero delle finanze*, 1997.

41. So similar to the income tax that the Italian literature, as mentioned above, complained about a change in the policy of Italian legislator that in the past used to discriminate in favor of labour income compares to income from capital; a goal that cannot be achieved by way of the EU VAT.

42. See once again paras. 28 and 30 of the ECJ decision on the IRAP case, C-475/03, cit. See also ECJ, 26 June 1997, C-370/95, *Careda*, where the court held that "*According to settled case-law (see, in particular, Case 295/84 Rousseau Wilmot [1985] ECR 3759, paragraph 16, and Case C-347/90 Bozzi [1992] ECR I-2947, paragraph 9), in leaving Member States free to maintain or introduce certain indirect taxes, such as excise duties, on the condition that they are not taxes which can be 'characterized as turnover taxes', Article 33 of the Sixth Directive seeks to prevent the functioning of the common system of VAT from being compromised by fiscal measures of a Member State levied on the*

As already noted,[43] and in line with the suggestions of the literature we quoted above, it appears that the ECJ confirmed that the relevant difference between the VAT and the IRAP does not really lie in the tax base, as, most importantly, in the way the tax is applied.[44]

movement of goods and services, and charged on commercial transactions in a manner comparable to VAT".

43. de'Capitani di Vimercate, *Iva e IRAP: due tributi di segno opposto*, in *Dir. prat. trib.*, 2006, II, 1302.

44. We cannot, however, overlook the precedent of the ECJ, 26 June 1997, C-370/95, *Careda*, although the facts of that case were quite specific and therefore not comparable to other cases and other taxes.

Value Added Tax and Direct Taxation
Similarities and Differences

Consumption taxes (such as value added tax (VAT) or goods and services tax (GST)) are generally very different from direct taxes. For this reason, research in the two areas of tax law has for the past decades generally been compartmentalized. Some issues, however, appear to be very similar in both fields. Thus, although different principles are applied, there is much to gain from an exchange of knowledge, especially in the field of cross-border transactions. It therefore seems useful to identify and discuss similarities and differences, as well as to evaluate how solutions in one area can be used in the other. Using consumption taxes as its starting point, this book aims to build a bridge between consumption taxes and direct taxes.

This book provides the first comprehensive in-depth analysis of the similarities and differences between consumption taxes and direct taxes. Fifty contributions are included, written by distinguished academics, practitioners and representatives from several international tax administrations and institutions.

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