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VAT and the expanded VAT law

The Value Added Tax (VAT) Reform Act (Republic Act 9337), more commonly known as the expanded VAT (E-VAT) law, was passed by Congress in May 2005. After some objections on its legality, it was finally implemented on November 1. This law provides for (i) the expansion of the coverage of the VAT, (ii) reduction in the excise tax on certain petroleum products, and (iii) increase in the corporate income tax rate.

What is the VAT?

The VAT is essentially a tax on consumption and is levied on the sales of goods and services at each stage of the production and distribution process. The burden of the tax is borne by the final consumers of VAT-able goods or services (i.e., goods and services subject to VAT) although the producers and suppliers of these goods and services are the ones who have to file their VAT returns to the Bureau of Internal Revenue (BIR).

The VAT system was first adopted in the Philippines in 1988 in place of the sales/turnover tax and a host of other taxes. At present, a single rate destination principle value added tax equivalent to 10 percent is imposed on the gross selling price of VAT-able goods (or gross receipts in the case of VAT-able services). The advantage of the VAT is that revenue is secured by being collected throughout the production/distribution process and production decisions do not get distorted due to the tax credit provision on inputs.[1]

So what is new with the E-VAT?

VAT rate. Under the reformed VAT law, the 10 percent VAT rate is retained. However, it grants a stand-by authority to the President to raise the VAT rate to 12 percent on January 1, 2006 if either one of these conditions exists: (i) VAT collections in 2005 exceed 2.8 percent of gross domestic product (GDP), or (ii) National Government deficit for 2005 exceeds 1.5 percent of GDP. Recent discussions suggest that the VAT rate can be adjusted to 12 percent only on February 1, 2006 at the earliest because data on the 2005 GDP which are needed to justify the change will not be available until then.

Shift in nature of the VAT. Prior to the latest amendment, the Philippine VAT was said to be a "consumption type" VAT which means that firms were allowed to immediately claim credit for the VAT that they paid on capital goods.

In contrast, under the reformed VAT law, firms are no longer allowed to immediately claim full credit for the VAT they paid on capital goods. Instead, they are now required to spread out their claim for VAT credit on capital good purchases over five years.

This provision effectively makes the Philippine VAT an "income-type" VAT where producers will effectively bear a "tax" on their capital purchases that is equivalent to the cost of money. This will tend to distort producers' decisions and discourage more capital-intensive type of activities/sectors and technologies. While this bias might be less of a concern in a labor-surplus economy like the Philippines, it is important to remember that an income-type VAT would introduce some element of tax cascading.[2]

The reformed VAT law also places a cap on the amount of VAT credit that firms may claim for their input purchases. Specifically, it limits the VAT credit for inputs to 70 percent of output VAT, thereby possibly creating a bias against activities/sectors that have a high intermediate input content. It appears to have been driven by concerns that producers are claiming more input VAT credit than is warranted, something that might have been better addressed by benchmarking in VAT administration.

VAT coverage and mitigating measures. Under the E-VAT law, the exemptions of certain transactions from the VAT were lifted such as sale or importation of coal and petroleum products; sale of electricity by generation, transmission and distribution

[1] The Philippine VAT is collected using the invoice or the tax credit method. In computing for one's VAT liability, a VAT-registered taxpayer can deduct input tax (VAT paid for purchases of raw materials, supplies, and capital goods) from output tax (VAT due on the taxpayer's sale of goods and services).

[2] An item is taxed more than once as it makes its way from production to final retail sale.

companies; services rendered by doctors of medicine and by lawyers; sale of cotton and cotton seeds in their original state; sale of nonfood agricultural and marine and forest products in their original state; and sale of works of art, literary works, musical composition and similar creations. *Thus, the VAT base is effectively broadened*.

Some mitigating measures are introduced under the new VAT law to offset the impact of the above expanded coverage. For instance, the price increment of petroleum products due to VAT is expected to have a significant effect on transportation costs. However, said price increases will be partly negated by the reduction in the excise tax on diesel, kerosene and bunker fuel oil.[3] Since diesel-powered vehicles are more frequently used in public transportation, the rise in land transportation fares will be mitigated. The same holds true for the price of transporting cargo.

Moreover, to reduce the effect of the VAT on the price of electricity, the 3 percent franchise tax on power distribution utilities was also removed. For domestic carriers by air which are now fully covered under the expanded VAT, the franchise tax under their charters had been abolished as well.

Consumer vigilance is therefore required to ensure that unscrupulous producers do not take advantage of probable confusion on the effect of the broadened VAT coverage to justify unreasonable increases in the price of basic commodities.

Earmarked funds. Under the old VAT system, the entire VAT collection went to the Bureau of the Treasury and could be used by the government for any purpose. Under the reformed VAT law, however, half of the local government units' (LGUs) share in the incremental VAT collection (which would be available to them after three years) is earmarked for social and economic services. In particular, 15 percent goes to public school buildings and furniture and in-service of public school teachers in the elementary and secondary levels; 10 percent to health insurance premiums of indigents; 15 percent to environmental conservation; and 10 percent to the construction of farm-to-market roads and irrigation facilities.

Non-VAT provisions. The reformed VAT law contains other provisions that affect other taxes, to wit:

- raising of the corporate income tax rate from 32 to 35 percent up to the year 2009; and
- increase of gross receipts tax from 5 to 7 percent on royalties, rentals of property, real or personal, profits from exchange and all other items treated as gross income of banks and nonbank financial intermediaries.

[3] Based on the DOF VAT Reform Law briefer, estimated increases due to VAT in the prices of petroleum products such as unleaded, regular, diesel, kerosene, bunker, and LPG would be 8.2 percent, 6.9 percent, 2.5 percent, 6.1 percent, 6.6 percent and 7.9 percent, respectively, instead of the full 10 percent.

[4] Collection efficiency of the VAT is the ratio of the actual VAT collection to the potential VAT revenue. Thus, an assumption of 70 percent collection efficiency means that 70 percent of the estimated potential VAT revenue would be collected by the BIR.

What prompted the Government to make the reforms?

The reformed VAT law aims to generate additional revenue equivalent to 2.5 percent of the projected GDP for 2005 to address the current fiscal condition. Based on the estimates from the Department of Finance, the E-VAT will generate additional revenues amounting to more than P80 billion in 2006, a large part of which is expected to come from the lifting of VAT exemptions with potential revenues amounting to P39 billion. All of these projections, though, are based on a 70 percent collection efficiency.[4] Thus, the deteriorating collection effort needs to be addressed and strengthened to ensure the success of the reformed fiscal measure. ❋

References

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