CHAPTER 4 WHAT IS GST AND HOW DOES IT WORK?

GST is a multi-stage indirect tax levied on local consumption

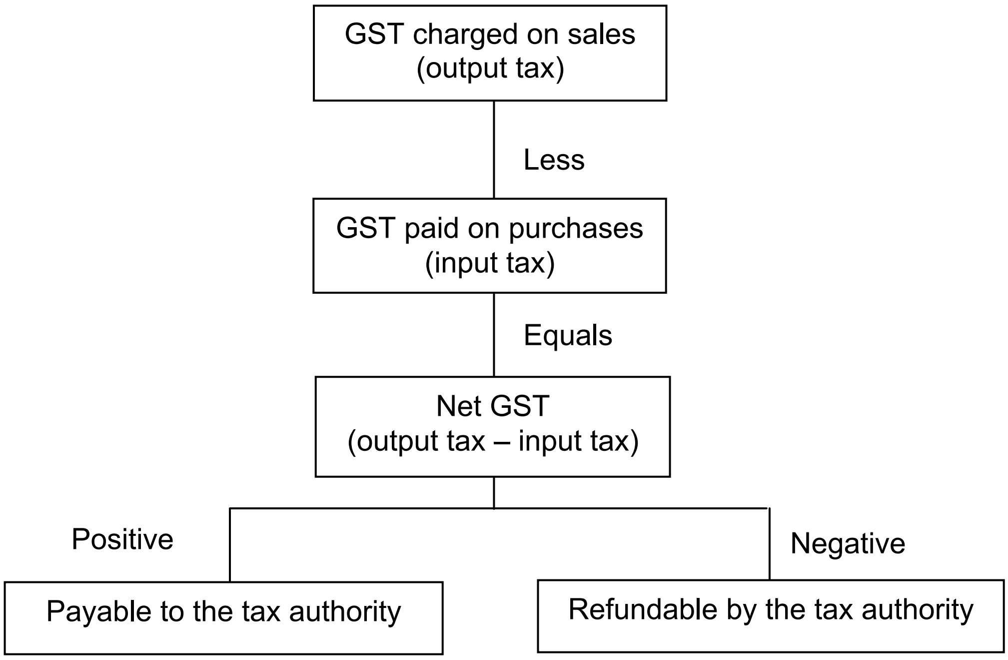
69. GST is also known as "Value-Added Tax" (VAT)[13] in some parts of the world. The reason for this is that, although it is charged on local consumption and is borne by end consumers, it is collected at each stage of the production and distribution chain by registered vendors, who have to account for the tax on the value that they have added to goods and services.

70. The GST that is charged by the vendor on its supply of goods and services is known as "output tax". On the other hand, the tax that the vendor has paid for the purchase of its inputs is known as "input tax". Under the GST tax credit mechanism, the vendor can "net off" its output tax liability against its input tax credit to arrive at the "net GST payable" (if the amount is positive) or "net GST refundable" (if the amount is negative). The vendor is required to remit the "net GST payable" amount to the tax authority (which would be the Inland Revenue Department (IRD) in the case of Hong Kong) in accordance with the prescribed procedures, and the vendor is entitled to a refund of the "net GST refundable" amount from the tax authority in accordance with the prescribed refund rules.

[13] VAT is the name used throughout the EU and in South Africa. GST is the name used in, e.g. New Zealand, Canada, Singapore and Australia.

The following flowchart illustrates how the GST tax credit mechanism operates:

Chart 9 GST tax credit mechanism



Definition of supply

71. Under a GST, there are three types of supply:

(a) Taxable supply – a supply that is subject to output tax (GST on sales) and entitles the vendor to reclaim input tax (GST on purchases). This is often referred to as a standard-rated supply;

(b) Zero-rated supply – a supply that is not subject to output tax, but still entitles the vendor to reclaim input tax; and

(c) Exempt supply – a supply that is not subject to output tax, and does not entitle the vendor to reclaim any related input tax. In this case, the vendor is effectively treated like an end consumer.

"Supply" is a very broad term covering the sale of goods, services, intangibles and real property.

How does GST work?

72. As GST is a multi-stage tax, it involves collection by registered vendors throughout the production and distribution chain before the goods or services reach end-consumers. Under the GST framework, each registered vendor charges GST on his sales, and reclaims credits for the tax paid on his purchases. The total amount of GST paid to the tax authority by all the vendors in the production and distribution chain is equal to the amount of tax finally borne by the consumer. Below is a hypothetical case showing how GST is charged through a production and distribution chain, using the example of the manufacture and sale of a suit, assuming a 5% GST rate is levied and each vendor is registered under the GST system.

Table 3 An example of how GST is charged

	Purchase			**Sale**			
	Price before GST ($)	GST (input tax) ($)	Price paid ($)	Price before GST ($)	GST (output tax) ($)	Price charged ($)	GST paid to the tax authority (output tax less input tax) ($)
Raw Material Vendor	-	-	-	500	25	525	25
Fabric Maker	500	25	525	1,000	50	1,050	25
Tailor	1,000	50	1,050	1,500	75	1,575	25
Retailer	1,500	75	1,575	2,500	125	2,625	50
Consumer	2,500	125	2,625				
Total GST							125

Illustration

Raw Material Vendor

(a) The raw material vendor sells the cotton to the fabric maker for $500 plus $25 GST. Therefore, the total price paid by the fabric maker is $525. At the end of the relevant GST period, the raw material vendor needs to account for the $25 of GST (output tax) he has charged, less the amount of input tax he has paid, which is $0 in this case, and remit the net amount of $25 to the tax authority.

Fabric Maker

(b) The fabric maker processes the cotton into suit material and then sells the material to the tailor for $1,000 plus $50 GST. Therefore, the tailor pays $1,050 to the fabric maker. When it is the time for the fabric maker to submit his GST return, he accounts for the $50 of output tax collected from his sale to the tailor, less the $25 of input tax that he has paid on his purchases, giving him a net GST amount of $25, which he pays (with his GST return) to the tax authority.

Tailor

(c) The tailor sells a completed suit to the retailer for $1,500 plus $75 GST, which totals $1,575. The tailor has collected $75 of output tax on his sale. He subtracts the $50 of input tax on his purchases to arrive at a net GST amount of $25, which he then remits to the tax authority.

Retailer

(d) The retailer displays the suit in his shop and then sells it to a consumer for $2,500 plus $125 GST. The retailer has received $2,625 from the consumer. To comply with his GST obligations at the end of the GST period, he needs to remit the net amount of $50 (which is output tax of $125 less input tax of $75) to the tax authority.

Consumer

(e) The consumer has bought the suit from the retailer for $2,625, including the $125 GST. He effectively bears the entire burden of the $125 GST in the final price he pays to the retailer. As he is not a registered person and does not use the suit as a business input, he has to bear the full amount of tax.

Tax Authority

(f) The tax authority receives GST payment of $25 each from the raw material vendor, fabric maker and tailor, and $50 from the retailer. In total, the tax authority receives GST of $125 for the suit (equivalent to the amount paid by the consumer), which is collected progressively through the production and distribution chain.

Why GST rather than Retail Sales Tax?

73. GST is not the only form of general consumption tax. It is often compared with Retail Sales Tax ("RST"), which is an indirect tax levied at the retail stage where goods pass from retailers to end-consumers. RST is normally only applied to goods – but not services, which represent the greater and growing part of a modern economy's consumer spending.

74. As a single-stage tax levied at the product's final point of sale, RST may be perceived as a simpler way of taxing general consumption. However, a more detailed examination reveals that it has a number of inherent problems, rendering it not as effective or efficient as GST.

75. As RST is levied at only one stage of the production and distribution chain, it requires detailed rules to define when a seller is a "retailer" and should be registered and levy RST on its sales. Moreover, clear rules are required to distinguish the circumstances in which a buyer is only an intermediary, such as a wholesaler or trader, in the production chain, and should therefore be exempt from payment of RST.

76. In addition to the legislative and administrative complexities involved in a RST regime, this tax has proven to be very susceptible to abuse or fraud, as it is all collected at only one stage. In contrast, GST, being a multi-stage tax, is self-policing and has a lower risk of revenue leakage. In view of GST's inherent advantages over RST, many jurisdictions, over the past two decades, have replaced their sales tax systems with a GST. More than 135 jurisdictions around the world have already implemented a GST.

Question

✧ Do you agree that GST is preferable to RST as a form of general consumption tax?