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The Current Legislative and Administrative Issues of the Value Added Tax System in Armenia

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Abstract

This paper is devoted to the analysis of legislative and administrative issues of the VAT systems of economies in transition and specifically of Armenia. The authors outline the structure and the function of Armenian VAT system, present the problems that exist in the field, discuss political, social and economic implications of VAT issues, and provide recommendations for resolving existing problems. The views presented in this document are of the authors only and do not represent the official opinion of the Government of Armenia or the State Tax Service of Armenia.

The views expressed in this Working Paper are those of the authors and do not necessarily represent those of the Armenia International Policy Research Group. Working Papers describe research in progress by the authors and are published to elicit comments and to further debate.

Keywords: value added tax, VAT, tax system, tax administration, state budget

I. Introduction

The formation of tax system of Armenia and definition of main taxes (income tax, profit tax, VAT, etc.) began immediately following the establishment of independence of Republic of Armenia in 1992. The decree NH-49 regarding «The Taxation of Enterprises, Organizations and Citizens» was signed by the President of Armenia on January 4th 1992. The effective taxation of Republic of Armenia began in 1993 following the signing of new tax legislation by the Parliament. The initial stage of formation ended in 1997-1998 with the signing of the new laws regarding taxation.

VAT is the most important of the indirect taxes in Armenia since it comprises approximately half of the total annual tax collections. Opinions regarding the nature and fairness of VAT vary amongst the economists: some specialists consider this tax of uttermost importance for the budget of country, while others claim that VAT is effectively regressive taxation which puts unjust burden on the poor layers of society.

This presentation will outline the main problems of VAT system, present legislative and administrative peculiarities of VAT in Armenia, and suggest the possible methods of solving VAT-related issues. Some policy implications and recommendations are presented at the end of the paper.

II. Conceptual Aspects of the VAT System

Unlike many other types of taxes, the VAT tax is relatively new. The inventor of VAT was a French economist Moris Loren, who created and described the mechanism in 1954. The term «Value Added Tax» (in French “taxe sur la valeur ajoutée” or TVA) was also coined by him. Initially, the VAT has been put into practice in France as soon as 1968. Since then, the VAT gained popularity with unprecedented speed and conquered a tangible role in budget incomes of many countries in the world. The implementation of VAT in any country, and especially in a developing country, is an important political and economic event.

The VAT system is a rather complicated legal and economic structure. Decisions regarding the VAT should be after careful consideration of the political, economic and social peculiarities of the country, the incomes of the population, general level of tax loads, level of development of accounting system and level of integration of economy. The problems that VAT is expected to solve should be clearly defined prior to implementation. The level of foreign integration of the country and the balance of trade are also very important. From this broader point of view, the VAT system should be comprised of legal regulation, policy implemented in adjacent legal field and in tax compliance administration, implementation of tax supervision and administration, and principal standpoints of implementation of the tax.

While implementing the VAT system the following principal issues were taken in consideration in Armenia:

1. Definition of the minimal level of taxation for the taxpayers, the taxed deals, small and middle taxpayers.

It is important to clearly distinguish the organizations and individual taxpayers, which must be registered as VAT payers and act as enterprises in the VAT field. In Armenia the minimum level of taxation for the non-registered taxpayers (citizens) is defined to be 3 million drams (about \$6500) and for the registered taxpayers (private entrepreneur and organizations) there is no minimal level of taxation defined. All of these organizations must pay VAT, except for the certain types of activities which are outlined as exceptions.

2. Invoice basis system.

The ability of making deduction is the central and the most important element in the VAT. From the point of view of calculation there are a few options for calculating VAT. However, in most countries (also in Armenia) that use VAT, the VAT calculation is made by the method of invoices. In this case the VAT computation mechanism is based on vouchers reflecting VAT paid when supplies are purchased. The taxpayer then deducts the

VAT paid in computing the VAT due upon the subsequent sale of goods or supplies subject to VAT. Taxpayers pay VAT quarterly, and only large taxpayers on a monthly basis.

3. The "destination principle" (place of supply) and "country of origin" dilemma, which is one of the central issues related to the VAT system. In the Law of RA "On Value Added Tax" which was accepted in 1997 and which is active to date the "destination principle" of VAT calculation is adopted. The implementation of the "destination principle" is mainly due to the fact that VAT is a tax of inner consumption and aims at taxing the expenses of spent by the consumers for attaining products and services within the country. The VAT is collected in the countries where the products are eventually consumed and not in the countries where they were produced. To put it in other words, in the countries where this principle is practiced the export VAT rate is zero and the imported products are subject to taxation in the country that imports (consumes). The place of supply in the field of VAT is the pre-eminent instrument to avoid double taxation or non-taxation. Nevertheless the subject of double taxation or non-taxation in VAT has aroused little general interest; as a consequence no separate study has been conducted in this field.

Table 1: Foreign Trade Turnover of Armenia, 1998-2005¹
/million USD/

Year	Export	Import	Total	Weight of Export (%)	Weight of Import (%)
1998	220,5	902,4	1 122,9	19,60	80,40
1999	231,7	811,3	1 043,0	22,20	77,80
2000	300,5	884,7	1 185,2	25,40	74,60
2001	341,8	877,4	1 219,2	28,00	72,00
2002	507,2	991,0	1 498,2	33,90	66,10
2003	685,6	1 277,9	1 963,5	34,92	65,08
2004	722,9	1 350,7	2 073,6	34,86	65,14
2005	950,4	1 767,9	2 718,3	34,96	65,04

4. Privileges (such an exemption) related to VAT and the limits of implementation of zero rate.

The privileges related to VAT in Armenia occur mainly as exemption of VAT. In Armenia, the Law of RA "On Value Added Tax" outlines many major areas of exceptions, which are categorized as follows:

- Social, educational and health spheres,
- Agriculture (taxation will be introduced in 2009),

¹ National Statistical Service of Armenia. Yearbooks. 1999-2006.

- Financial, banking and insurance spheres,
- Humanitarian aid and charitable programs, projects implemented by means of international organizations.

5. One or a few VAT rates.

From the beginning of the VAT implementation in Armenia the VAT rate was 20%. While the application of differentiated rates can be justified from the point of view of social justice, alleviation of regressive tax and economic standpoint, there are major reasons which support the application of a single VAT rate. In addition, the application of differentiated VAT rates creates additional complexities in the administration of VAT and creates uncertainty when closely related or similar product families can be taxed with different tax rates. All things considered, there is little doubt that from an administrative point of view the implementation of one common rate is preferable both for the state and for the taxpayers.

It is noteworthy that the Law of RA “On Value Added Tax” was drafted following an EU Sixth Directive² on VAT and in general complies with international standards, especially the drafting procedures. Nevertheless, problems have become evident which, if discussed and addressed, will significantly improve tax administration.

Some of the problems are discussed in the sections that follow.

² Sixth Council Directive "On the Harmonization of the Laws of the Member States Relating to Turnover Taxes - Common System of Value Added Tax: Uniform Basis of Assessment", 17 May 1977, 77/338/EEC

III. Fiscal Importance of VAT for the State Budget and Effective VAT Tax Base

The Value Added Tax has very significant fiscal importance in many countries and plays a major role for state budgets due to its large tax base. The VAT can ensure relatively large budgetary incomes even in case of very low tax rates. Similarly to many Western economies, Armenian VAT system was implemented because of its large fiscal potential. However in the early years of its application, the VAT did not result in large income for the state budget of Armenia. Such situation was created due to several reasons, mainly:

- Confusion which was created by the introduction of new tax without adequate education
- Deep economic crisis in the country following its declaration of independence
- Resulting lack of demand in the market
- Inability of State Tax Service to ensure voluntary tax compliance system in the country

The level of tax compliance is considered to be one of the main criteria for estimating the efficiency of VAT. The “level of compliance” is the proportion of taxes collected by the state versus the overall tax which is classified as subject to collections through consideration of the actual potential of the economy and the legal system. Implying this proportion for VAT one can fix, that the degree of VAT compliance is the weight of the monetary means provided to the state in the value added tax created in the country.

To analyze and estimate the degree of VAT compliance in Armenia one must first estimate the potential size of VAT collections in Armenian economy. More specifically, one must estimate the efficient base of VAT taxation, or the amount that is theoretically subject to payments into state budget under the actual conditions of economy and the legal system.

The precise calculation of potential VAT of the Armenian economy is a rather complicated process and calculations that are based on any macroeconomic indicator can provide only an approximation. Using the most recent analysis and calculations conducted by the efficient base of VAT taxation in present day Armenia is only 60 percent of the GDP.

For calculating the efficient base of VAT taxation, one must consider the large not-taxable spheres of the economy. Armenian agriculture is currently not subject to VAT collections. Agriculture carries the weight of invested value added tax in the GDP makes up 29-30 percent of GDP, financial-banking, health and education comprise 7-10 percent of GDP, and humanitarian aid, charitable programs and international donor projects comprise 5-10 percent of GDP.

It should also be mentioned that the proportion of the shadow economy is not considered in the aforementioned calculations. If we try to consider the portion of the shadow economy in Armenia, the efficient tax base of the VAT will appear even smaller. However, many economists argue that it is not valid to claim that “shadow organizations” do not, at least indirectly, pay the VAT tax. If a shadow organization is out of the tax field and does not calculate and pay for the business it conducts, it still pays VAT for the majority of its inputs. In other words, authors believe that it is not valid to claim that the organizations in the shadow economy are wholly in the shadow field and deal exclusively with the shadow providers. However, it is almost impossible to estimate and define the “extent of being in the shadow» and its complete effect on the sphere of taxation.

Year 1997 was chosen to be a starting point for calculating VAT efficient base in Armenia. The starting year was defined as the year of actual and effective implementation of VAT in Armenia, and the year in which the new Law of RA “On Value Added Tax” was signed by president. The table below demonstrates the level of compliance throughout years 1997 until 2004.

Table 2: The level of VAT compliance in Armenia in 1997-2004 /in billion drams/

<i>Year</i>	<i>GDP</i>	<i>Effective Tax Base («2» x 60%)</i>	<i>Potential VAT in effective tax base («3» x 20%)</i>	<i>Actual VAT Revenues</i>	<i>Level of Compliance (%)</i>
1	2	3	4	5	6
1997	804,3	482,6	96,5	37,4	38,8%
1998	955,4	573,2	114,6	59,5	51,9%
1999	987,4	592,5	118,5	68,3	57,6%
2000	1031,3	618,8	123,8	66,8	54,0%
2001	1175,9	705,5	141,1	79,5	56,4%
2002	1362,5	817,5	163,5	95,0	58,1%
2003	1624,6	974,8	195,0	107,8	55,3%
2004	1896,4	1 137,9	227,6	117,9	51,8%

As one can observe from the data presented in Table 2 that the level of compliance of VAT has continuously grown in 1997-2002, rising from 38.8 percent to 58.1 percent. Notably, the largest annual growth of 13.2 percent has been in marked in 1998. This growth can be attributed to the effect of the adoption of the new Law of RA “On Value Added Tax” (HO-118, adopted on May 14, 1997; effective beginning July 1, 1997).

The average annual growth of VAT level of compliance was 2-5 percent throughout the past 8 years. It should be stressed that the corresponding growth paces have been ensured

under the same rate. Obviously, the numbers imply that the accepted efficient tax base is inversely proportional to the level of compliance.

At the same time its important to note that in the years 2003 and 2004 there was a downward movement of the level of compliance. This trend can be attributed to a wide range of circumstances. First, in parallel with the development of the economy, the money flows that are subject to taxation gradually move away from the indirect taxation and into the sphere of direct taxes. Such process is evident from the fact that in the past two years the flow of money from the profit tax and income tax into the state budget of Armenia have increased. On the other hand, undoubtedly the facilities of tax inspectorates that are tasked with supervising and the methods of ensuring compliance are outdated and lag behind the pace of modernization which has been observed throughout Armenian economy.

However, we believe that it is possible to raise the level of VAT compliance to 65-70 percent in the near future. Such change can be achieved through the implementation of specific policies through legislative amendments, gradual limitation of authorities, as well as fostering the administration in the VAT sphere and eliminating opportunities for avoiding the payment of taxes.

Chart 1: *The Level of Compliance of VAT in EU³*

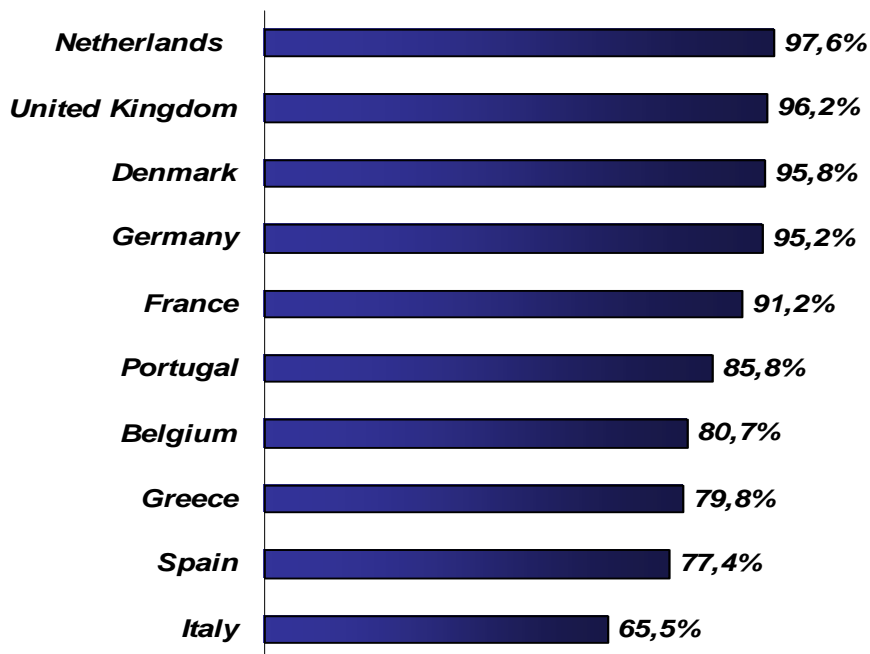


Chart 1 indicates that the level of compliance in the countries of the European Union is very high, ranging from 65 percent to over 97 percent in the top 10 countries of EU.

³ M. Gorban, S. Guriev. "VAT administration: Need we the reforms?". CEFIR, Moscow, 2003

Arguably, the smaller scale of the shadow economy in the countries listed, the highly developed taxation and sophisticated business culture, high level of development of VAT system and extensive experience in the implementation of the tax support high VAT collection rates. It should also be mentioned that the level of VAT compliance is high in the countries which have implemented the VAT relatively early and which are called “The First Generation Countries of VAT”.

One of the most widely used indicators for estimating efficiency of VAT systems is the extent by which the state income is provided by 1 percent rate of the implemented VAT. It is calculated as the proportion of weight of VAT in the GDP and the active rate. The growth of budget receipts from VAT expressed in absolute values was first fixed in 1994, however the opportunities of the 20 percent rate was not fully utilized during those years.

As we see from Table 3, in Armenia 1 percent rate of VAT during years of 1998-2004 has ensured 0.31-0.35 percent income for the GDP and has almost doubled the numbers of 1994-1997. This progress is a result of both continual work conducted in the sphere of legislative regulation of VAT issues and the efficiency of administration of taxation in VAT sphere.

Table 3: The weight of VAT in the GDP of Armenia and in the state budget tax income from 1994 to 2004⁴ /in billion drams/

Year	GDP	Tax revenues		Value added tax			
		Amount	Percent In GDP	Amount	Percent in GDP	Percent in tax revenues	VAT incomes provided by 1 percent rate (percent of GDP)
1994	187,1	20,5	10,9%	4,9	2,6 %	24,1%	0,13
1995	522,3	56,1	10,7%	17,0	3,3%	30,4%	0,16
1996	661,2	69,1	10,5%	21,2	3,2%	30,7%	0,16
1997	804,3	102,9	12,8%	37,4	4,7%	36,4%	0,23
1998	955,4	125,0	13,1%	59,5	6,2%	47,6%	0,31
1999	987,4	154,2	15,6%	68,3	6,9%	44,3%	0,35
2000	1 031,3	149,1	14,5%	66,8	6,5%	44,8%	0,32
2001	1 175,9	159,4	13,6%	79,5	6,8%	49,9%	0,34
2002	1 362,5	190,0	13,9%	95,0	7,0%	50,0%	0,35
2003	1 624,6	218,3	13,4%	107,8	6,6%	49,4%	0,33
2004	1 896,4	257,5	13,6%	117,9	6,2%	45,8%	0,31

⁴ National Statistical Service of Armenia. Yearbooks. 1994-2005.

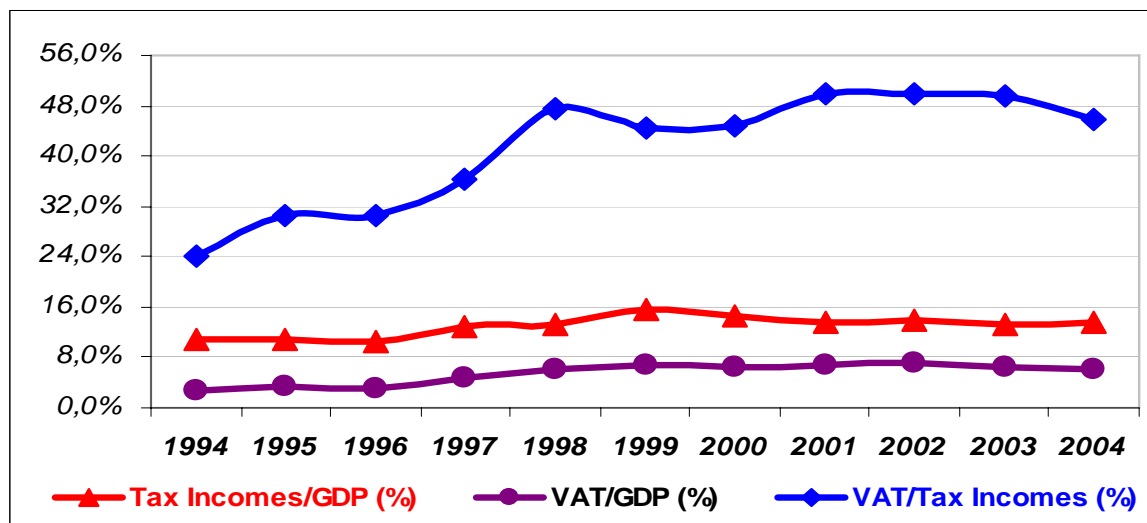
At present time this indicator (VAT incomes provided by 1 percent rate) makes up an average of 0.36-0.40 percent for the countries that implement VAT⁵. Therefore, Armenia is not lagging too far behind in this indicator. However, the large negative trade balance of the Republic of Armenia suggests that this indicator must be at a higher level. For comparison, it should also be stated that in other countries of the Former Soviet Union this indicator averages 0.34 percent. Again, in comparison to FSU the indicators in Armenia are satisfactory.

As mentioned earlier, the growth which has been observed in 1998 was greatly influenced by the fact that from the 1st of July 1997 the VAT was conducted by the customs of Republic of Armenia (with some exceptions). Such situation tangibly raised the efficiency of compliance and reduced the administrative costs.

In addition, the VAT specialists have discovered that on average each passing year of the implementation of VAT increases the level of compliance on average by only 1 percent. Generally, the VAT contributes from 12 percent to 30 percent of revenue in most countries, representing about 5-10 percent of gross national product.

The pace of growth of tax incomes, as well as the role of VAT in GDP and the weight of VAT in GDP from 1994 to 2004 is presented in Chart 2 below. The numbers presented in the chart make the pace of increase of the role of VAT in the income even more obvious.

Chart N 2: The dynamics of the growth of state budget revenues and the weight of VAT in the tax income of Republic of Armenia and in GDP from 1994 to 2004



As shown in the chart the pace of growth of VAT in the GDP are in agreement with the pace of growth observed in GDP when the tax incomes grow about 3-4 percent. Meanwhile, the weight of VAT in tax incomes has almost doubled or grown with almost 25 percent points during the past 9 years.

⁵ "Recent Experience with the Value-Added Tax - An Overview", IMF Working Paper (EBS/00/14), 2000.

At the same time we must note that parallel with the economic development of Armenia, there are tendencies of the growth of indirect taxes, confinement of VAT taxation field, decline of significance of VAT in budget income. On the other hand, naturally, the direct taxes will grow even if today's VAT rate persists. Similar changes may take place partly due to the stable growth of value of exported production that can be observed in Armenia during the past few years. Another reason is the growth of incomes of the country's general population.

However, relatively large budget receipts from direct taxes may be expected only in case of tangible and real growth of incomes in all spheres of economy and of all citizens. We believe that it is unrealistic to expect such a strong trend in the near future.

IV. Current Legal and Regulatory Issues of VAT

The Law of RA “On Value Added Tax” which is the main legislative act in the area of VAT was adopted by the Armenian Government in 1997. Since then, it has been updated and amended numerous times. The Law of RA “On Value Added Tax” has many conflicting articles and it does not reflect the level of economic development in the country. The law needs to be updated and improved to respond to the realities in Armenia today

There are several legislative issues in the area of VAT. This paper will address, in particular, the following issues:

1. The first major area which is not clearly defined in Law of RA “On Value Added Tax” refers to the question of “who and at which point should be considered a taxpayer of VAT”.

According to the law, the individuals and organizations carrying out independent economic (entrepreneurial) activity in accordance with the procedure defined by the law and implementing transactions (operations) listed in article 6 of the law shall be considered VAT payers.

Two questions arise from reading the law and its definitions:

- a. Article 2 of the Law of RA “On Value Added Tax” refers to “entrepreneurial” activities, but the definition of such activities differs between this law and the Civil Code of Republic of Armenia. This discrepancy can negatively affect enforcement of the law and can be interpreted by the taxpayers in their interest.
- b. From the Law “On Taxes” it follows that if a taxpayer did not receive remuneration as a result of its economic activities it should not be paying VAT. However, the free supply of goods without payment is still considered to be a taxable transaction. In other words, the taxation of transactions is not tied to receiving profit.

2. According to Article 23 of the Law of RA “On Value Added Tax” taxpayers of VAT are entitled to a credit for VAT amounts collected by customs entities, and specified in tax invoices of suppliers in terms of goods procured (imported) and services provided. However, such credit or deduction is only allowed for the current VAT taxpayers which have been registered with the inspectorates. It follows that all of the VAT withholdings prior to the time when a legal entity has become a VAT taxpayer is not subject to credit and deduction.

Example: A new and registered company has not become a VAT taxpayer yet, as it has not engaged in VAT-taxable transactions. The company is planning to produce furniture. It

purchases production facilities, equipment and supplies to produce furniture. When the furniture is produced and sold (with VAT tax), the company can not deduct the VAT which has been paid on goods which were procured to produce the furniture, because it has not been a VAT taxpayer prior to this first sale transaction. Thus, Article 23 places an unjust burden on the new companies versus their existing competitors which have the right to deduct VAT. In this case, the new companies are forced to have a first selling transaction and become a VAT taxpayer prior to buying supplies and actually producing its products. Hence, article 23 creates a situation when to produce or buy something the entity must first become a seller.

3. From 1997, when the Law of RA “On Value Added Tax” was adopted, one of the most important rules that came into effect was that from now on the responsibility for calculating and paying VAT, as well as getting credit for VAT deductions, was to be conducted on delivery (VAT is due from the moment of delivery of goods and services). In other words, whether or not the taxpayer has sold the goods or services, the transaction is already a subject to VAT taxation. This is the method applied in all developed countries which utilize VAT.

However, after several amendments to the Law of RA “On Value Added Tax”, the method of “accruals concept” started working in only one direction. The government, or more specifically – the Law, requires that the VAT taxpayers calculate their tax responsibility by this method, but the credits and deductions can be made only after they have paid for purchased goods or services. This creates an unfair situation relative to the free entrepreneurial activities, and is a major defect in the current legislation as well as in the relationship between the government and the taxpayers.

4. In cases of VAT deductions, the Law of RA “On Value Added Tax” allows the possibility and the right to deduct amounts only in the simple trade relationships between economic market agents, i.e. buy-sell relationships. The law does not allow tax deductions on barter transactions, as well as in triangulation supply agreements (such as triangulation scheme in EU), as well as assignment clause agreements, etc. However, it would be fair for all of the taxpayers of VAT to have the right to deduct VAT independently from the form of payment and type of transaction. The law also does not establish the norms in the areas of high technology, e-commerce, etc. Considering the strong movement towards globalization and the continued integration of different economic systems, the Law of RA “On Value Added Tax” in Armenia should address and regulate all of the relationships that are outlined in typical legal systems of the world.

5. According to Article 20 of the Law of RA “On Value Added Tax” after the VAT reporting period taxpayers shall submit to their regional tax agency information about tax

invoices issued within the reporting period by suppliers in respect of purchased or received goods or services and those issued (for customers) by them for supplied goods and services.

The basic contradiction of this clause is the following, at first the Article says that information about VAT invoices must be provided by all taxpayers, but later specifies that the invoice information should be given only by VAT taxpayers. In this case, many disputes arise between taxpayers and tax authorities which involve interpretation of this part of the law. Take into account the fact that for unaccorded information in the legislation there are corresponding norms of the financial responsibility (especially in case of the invoices received from suppliers), besides not soft this question becomes even sharper.

6. Another VAT issue is the customs of Armenia often overestimate the value of the goods presented by VAT taxpayers at the point import. Therefore, the products that are subject to payment of VAT enter the market as "expensive" goods and with "expensive" VAT and with the "negative credit". Consequently, the taxpayers are unable to deduct the VAT amounts because of the negative difference between the accrued VAT liabilities from VAT taxable operations and VAT credits accrued on customs declarations.

V. VAT Exemptions: Validity of Exemptions from Economic Development Standpoint

Developing countries with VAT systems typically exempt a large number of goods and services from VAT. The tax system of Armenia also can be described as socially directed, and has given place to many sectoral tax exemptions. Most of the exemptions were on VAT and were given to whole economic sectors, whole groups of taxpayers or to specific goods or services. Although the government of Armenia had inherited politics of reducing the VAT exemptions – there is still a great number of them that do not work in real life. All these exemptions reduce the VAT tax base, offer opportunities for tax evasion for taxpayers. The government should go on reducing the number of VAT privileges and increasing the effective tax base. This in turn will be a good economic reason for decreasing the VAT rates.

“VAT exemption” does not mean exemption from the tax payment liability. In the case of VAT exempted supplies the exemption takes place only for the value added during the production (turnover). But the VAT is paid for the purchases for the production process - without the right to deducts.

So, when talking about the VAT exempt suppliers or goods we need take into consideration that they are exempted only from VAT calculation and collection liabilities, and not from the VAT tax burden.

1. Agricultural Sector

Now the biggest VAT exempt sector of the economy of Armenia is agriculture (nearly the 30% of the GDP). For all the countries with VAT tax systems, it's a great challenge to make taxation mechanisms for agricultural sector, farmers and individual agricultural households. According to the law on VAT - the sale of agricultural products by the producers themselves is not taxed by VAT (taxation will be introduced in 2009). But they are not totally freed from VAT, as in all the other cases. They pay VAT for all the purchases they make in order for their business to function (except from veterinary remedies, chemical weeds, fertilizers, cultured plants, perennial plants' seeds and seedlings). For all the other purchases (like agricultural machinery, fuel, water and else) which make a great portion in the cost price of the agricultural goods - the VAT is paid.

It's worthy to mention that the VAT exemption here, as in all the other cases, can not be considered as a real privileges. The production of agricultural goods is standing on the first phase of the production-realization chain, therefore the paid but not deducted (added to the production costs) VAT sums are being accumulated during the whole production-realization process. From this standpoint it becomes clear that the simple VAT exemption of the first phase (without any compensations, as it is in case of Armenia) cannot become a base for a fair socially directed tax policy.

Even though the agricultural goods are expected to be taxed only by the year of 2009, there is a need to prepare for that from now. And the government of Republic of Armenia should pay a great attention on choosing the mechanisms of VAT taxation. Also several technical and administrative problems will occur, especially.

- Registration of all the agricultural households as VAT taxpayers (almost 300 thousand of them, in case that there are only 50 thousand registered taxpayers in Armenia),
- Great difficulties for individual producers, small and medium sized agricultural companies to keep VAT accounting, fill in VAT declarations, etc.,
- Administrative and technical problems for tax authorities.

2. VAT Exemptions for the Humanitarian Aid and Charitable Programs

More than is required to reconsideration the legislative field which regulates operation of organizations, carrying humanitarian and charitable economic programs in Armenia, as well as tasks on granting to these organization tax privileges on bargains, which can be made within frameworks of the mentioned programs. VAT privileges have special value – both in case of import and in case of bargains made on the territory of Armenia.

Now, according to the Law of RA “On Value Added Tax” - if there is nothing mentioned in the law or in the international agreements - the program is called as humanitarian by the state Commission Of Humanitarian Programs At The Government Of Armenia.

These programs, especially the ones that bring in humanitarian products in order to sell them, should be recognized as humanitarian only by the government of RA – regarding its social and economic policy priority. Besides, the VAT exemptions to the humanitarian aid projects should be given only when they are successfully accomplished according to the previously presented program.

3. VAT exemptions for precious and semiprecious stones and metals

We think that it isn't logical to give VAT exemptions for the sales of precious and semiprecious stones and metals, even taking into consideration the fact that jewelry is considered to be one of the most important and developing exporting sectors of the economy of Armenia.

If it's a question of encouragement of export this goods and creation favorable conditions for a competition in the international market, in case of zero-rating VAT taxation for exported goods, all the sums of VAT paid in territory of Armenia are a subject of deduction, or will return to exporters.

More unacceptable the fact of VAT exemption of internal turnover of these products. VAT taxation of these goods cannot pose obstacle for development of this branch of economy. Precious, semiprecious stones, semi finished items from precious metals are not intended for final consumption and there are not the goods of the first necessity. On the other hand, any end-product can give as "semi finished item", here again there are greater an opportunity for tax evasion.

It's necessary to exclude the all non-final (interim) products from the list of VAT exempted products. Because, of the exemption of VAT during the first and the interim phases of production – consumption chain – the paid and no deducted VAT sums increase the cost of the goods, which then will pay the consumer.

VI. Opportunities for Improvement of VAT Administration System

Mechanisms of a state influence on economy through tax system cannot be invariable. It is critical for the government to periodically update those mechanisms and to make them agreeable with the changing requirements of the country's economy. In Armenia, many problems still exist with the development of the course of the country's tax system, particularly, in the field of tax administration. At the same time, it is necessary to note the efforts of the Armenian government towards developing a fair and effective tax system and improvement of tax relations. Many achievements and positive changes have been noted during the past several years.

Major tasks of legislative and administrative nature cannot be considered separately since they are often inter-dependent and associated with each other. Legislative changes are made with the goal of increasing tax administration effectiveness, improving existing administrative processes and enhancing the level of tax compliance.

Major tasks of administrative nature in a tax system of Armenia include both resolving the problems that are a result of general social-economic situation in the country, as well as issues of purely administrative and technical nature.

Several areas can be distinguished within the realm of tax administration.

1. Lack of VAT taxpayer accounting system

Despite the fact that Article 20 of the Law of RA "On Value Added Tax" contains provisions for an accounting system⁶, such system does not exist as of yet. In Armenia, each taxpayer has one taxpayer identification number (TIN). Establishment of a separate system for VAT taxpayers would make the mechanisms of recording, accounting and control more profitable.

2. Major administrative, technical and financial issues with VAT overpayments and credits

In Armenia, as well as in other countries with transitional economies, the problem of VAT credits to taxpayers is highly critical. This is in part due to country's limited budget and resources. It appears that taxpayers may have VAT overpayments of up to 65-70%⁷. The three main reasons for such overpayments are exportation, importation and advance payments. Unlike the last two (when the overpayments are temporary or short-term), the

⁶ Since 2002, the provision concerning application of VAT payers accounting system is established in the RA law of "Value Added Tax"

⁷ Based on personal analysis (official statistical data regarding VAT amounts returned to exporting organizations are not published in Armenia)

problem of VAT return due to exporting is more significant. These amounts are adjusted based on the results of examinations carried out by tax authorities. These tasks, one's turn, require heavy administrative costs on for State Tax Service. Thus, establishment of simplified procedures for bona fide taxpayers is highly critical. In particular, it is advisable to develop and apply a new “conventional exporter” concept. The concept would allow for establishing simplified procedures of receiving VAT credit for the country’s major exporters.

3. Tax calculation and payment control

Tax calculation and payment control is an important part of a tax administration. The control process is performed during audits which are carried out at the major taxpayers, as the majority of tax administration tasks are related to the auditing procedure. At present time, there is a rather liberal tax control and auditing procedure in Armenia. For example, the Armenian Law of RA “Audit Organization and Implementation in Armenia” established several provisions which impede a fulfillment of tax control. Particularly, in the opinion of State Tax Service, the requirement to inform a taxpayer about an audit three days prior to the start of the audit, as well as the limit on audit duration (15 working days), makes it almost impossible to engage the necessary experts in the auditing process.

Taking into consideration that an audit of each taxpayer may be carried out only once a year, there is no need to turn an audit into an end to itself. The need for relaxation of the audit rules mainly refers to bona fide taxpayers, which have shown in the past their ability and willingness to fulfill their obligations. Such principle would also support the notion of minimum interference in economical activity of businesses and must be applied especially to the taxpayers voluntarily complying with the tax rules. On another hand, it is also necessary to bring an institution of “office audits” into the tax legislation of Armenia and to reduce to a minimum a number of audits conducted at a taxpayer location.

4. Absence of accurate definitions and presence of alternative readings and contradictions in legal acts

The inconsistencies and inaccuracies result in disagreements and arguments between tax officials and taxpayers, especially during inspections and discoveries of tax infringements. In resolving these problems activities are typically carried out in favor of the taxpayer. In particular, when regulating tax-related contradictions, alternative readings of legal acts are typically treated and applied in favor of taxpayers. For example, in Article 2 of the Law of RA “On Taxes” Armenia, taxpayers have a legal right to appeal the actions of tax inspection officials at higher tax authorities or on trial ⁸.

⁸ The Law of Armenia “About taxes”, chapter VI, Articles 36-37 as well as The Law of Armenia about tax services” Article 43

5. The problems with false VAT invoicing

The invoice is a major part of VAT tax system. The main part of tax avoidance and tax crimes is connected to invoicing of VAT. Thus, one of the basic goals of tax administration of VAT is the supervision of tax invoices. Here, the problem of false tax invoices is considered one of the major problems of VAT administration. All law-enforcing authorities of Armenia, and not only the tax authorities, should be involved in the fight against false invoices and with those individuals who carry out the operation to create them. The attempts to avoid paying VAT or decrease VAT amounts that are subject to payment into state budget through using false tax invoices should be considered a crime. The strictest measures should be applied to the individuals who engage in these illegal activities.

6. Cross-checking of tax invoices

The supervision of the turnover of tax invoices is in a very poor state in Armenia. This is mainly due to inefficiencies of the general base for tax collection and poor technical support. In accordance with the Law of RA “On Value Added Tax” the processing of information that is presented to tax authorities (written and received tax invoices) lies in the hands of inspectorates. Receiving, processing and realization of this information are the main components in supervision of VAT taxes. However, the utilization and application of such information is also questionable, mainly because of absence of updated computer technologies to track the data. It is especially important to note that the presentation of hand written documents that are not the subject of record-keeping and archiving but are the subject of future processing. Here, the adoption of law on electronic signature becomes very important. The law is required to enable electronic turnover and storage of documents and at this stage such capability is not available in Armenia.

7. Automation of document turnover and storage

Both from the standpoint of general tax administration, as well as reducing VAT administrative expenses the use of information technology is a very important aspect. Automation has the potential to dramatically change the relationship between tax authorities and taxpayers. The taxpayers continuously present tax authorities with a number of different documents, such as calculations, accounting reports, etc. The use of email and other electronic means can significantly improve the work of tax authorities and taxpayers, with both parties realizing significant time savings and reducing administrative expenses.

8. Professional skills of tax employees

It is not a secret that many commercial organizations surpass the tax authorities in financial resources, level of technical preparedness and ability to choose skillful staff. These companies are also capable to attract various consulting companies and individual experts.

Taking this into consideration it is especially necessary to organize periodical training for professional development, studies and skill enhancement of the government employees as well. Increasing the level of preparedness and professionalism of tax authorities is critical for increasing the productivity of tax administration system. Appropriate training is also invaluable for improving the level of technical preparation.

VII. Conclusion

Summing up the report VAT legislative and administrative issues in Armenia, some suggestions and conclusions on VAT system improvement are given below .

1. Direct taxes play a prevailing role in the tax system of highly developed countries. Preference is given to indirect taxes especially to VAT in developing countries in the conditions of low income rate of population and high degree of sale tendency. In this case the significance of VAT in the sphere of budget revenue replenishment we consider to be legal and proved in the nearest future.
2. Armenian market is rather small and saturated and the goal of each Armenian big or medium company should be the external market. One of the most important questions of governmental tax policy should be the support and the provision of domestically produced products competition in the external market. The rate of Armenian economic development is undoubtedly determined by the export volume growth. Admitting that VAT plays a great role in the regulation of the questions mentioned above it is important to apply them for the benefit of VAT administrative and legislative reforms.
3. The deduction of VAT overpayments made by the taxpayers for exported goods or repayment of them and establishing simplified mechanisms especially for the main exporters.
4. All kinds of VAT privileges reduce VAT tax base, give opportunity to tax evasion and violations. In addition social privileges considered as support to the poor social stratum can not be proved worthwhile. We think that the governmental policy in the field of VAT should be directed to the gradual decrease of those privileges and the enlargement of tax base.
5. VAT 20% rate reassessment including rise and reduction of it is considered to be unacceptable. VAT 1%-2% rating reduction can't stimulate considerable increase of business activity in economy. In addition we are not of the opinion that rating reduction can stimulate the decrease of shadow economy ,of course if the question is not of double or triple rating reduction. More favorable conditions for VAT rating reduction can be provided in 2009 after adopting agricultural sphere in the VAT tax field. In our opinion some suggestions on applying of VAT differential rating are not acceptable because of difficulties of technical and administrative nature.. Activities to increase awareness of taxpayers and create transparency of activities conducted by State Tax Service. It is necessary to carry out activities which raise public awareness of VAT-

related issues. This can be done through involving various media channels such as TV and radio, as well as creating targeted press publications. In addition, newsworthy information on VAT tax evaders or improvements of the tax administration system can be distributed through news outlets.

6. Introduction of automatic systems of data processing and presentation of calculations.
 - a) Automation of the system of tax services, creation of global net and its future development, upgrading of computer systems, automation of taxpayer accounting, introduction of electronic record keeping.
 - b) Electronic processing of calculations and accounting information, automation of taxpayer activity presentation, automation of charging activities, etc.
7. To harden the responsibility for tax avoidance, moreover in the case of intentional and planned violations made against the governmental budget and economic system as a whole. Suggestions on hardening the responsibility may contradict the ideas of free market -based economy, however, on the other hand it will further to the benefits of responsible and law-abiding taxpayers. In addition the responsibility for tax payments determined by the law is one of the main principles in civil and business culture of each society and sooner or later the definition a “responsible taxpayer” will be one of the honorable notions in Armenia.
8. In the field of VAT effective system creation we point out the measures directed to the improvement of legislative field and the necessity of reformation in tax system. In all other respects any legislative reformation shouldn't be directed to the solution of daily and fiscal problems, but it must be oriented to the economical activity increase and VAT system improvement .in prospect .It must also be mentioned that the tradition of sudden changes in the field of VAT legislation and other judicial acts should be broken when the changes come into force a few days after being adopted .We think that every legislative reformation should come into force within 6-12months after being adopted giving an opportunity to tax payers of studying, preparing and matching those requirements to their business activity.
9. The statement mentioned above concerns export deals and especially service export, taking into consideration the fact that it is more difficult to record the fact of service export than goods export.
10. To give the right of VAT charging to the customs for the goods imported to Armenia by custom regime. As the experience shows the responsibility of VAT counting and payment at the custom border is more effective for budget income increase, reductions of administrative expenses and averts possibilities of tax avoidance.

11. Introduction of independent system of accounting for VAT taxpayers.
12. Introduction of peculiarities and simplified processes of VAT for small and medium taxpayers, private businesses and individuals.
13. Improvement of relationships between tax authorities and taxpayers. Improvement of mutual trust and creation of confidence between parties involved. In these relations setting of balance should be classified to the number of tax administration most important tasks as the productivity of tax system of the country in most cases depends on it.
14. For increasing the productivity of VAT audits it is necessary to create a subdivision in tax authorities which will consist of professionals in the main economic spheres. During the supervision process it is critical for the tax authority to understand the industries in which the taxpayers participate, as well as the structure of production and its performance in financial and production terms. Calculations of tax duties and correct collections are dependent largely upon the understanding of the factors above. Even the most skillful specialists of tax sphere can not be wholly aware of various spheres of economy's specialties. Thus by checking financial and accounting documentation, analyzing them and applying best practices from their previous experiences, they can be most effective in auditing the companies under their supervision and analyzing the results of company's business activities.

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