

THE NEW VAT STRATEGY: A PRAGMATIC APPROACH

Since 1 January 1993, when the internal market was created, a supposedly “transitional” tax and VAT system has been applicable to trade in the Community. Initially the system was intended to remain in force for four years, but it is still with us and there is no sign of any changes in the pipeline.

Since 2000, therefore, the Commission has elected to focus its efforts, not on replacing the existing system, but on improving the way it works.

1. CONTEXT

1.1. A system of taxing at the place of origin

Ever since it adopted its first and second VAT Directives in April 1967 (as part of the objective to create the most efficient common market possible), the Community has been committed to introducing laws and following policies aimed at establishing a common VAT system which eliminates import taxes and export tax exemptions in trade between the Member States. This commitment is in line with the objective of designing a VAT system geared to the internal market and working within the European Union as it would in a single country.

1.2. Establishing the Internal Market

The Commission put forward proposals for such a system in 1987 under the programme to create an internal market by January 1993. In 1989, when it became clear that it would be impossible to adopt these proposals by 1 January 1993, the ECOFIN Council decided to adopt instead a transitional system which would allow elimination of import taxes and export tax exemptions in intra-Community trade. But, on goods supplied between taxable persons and on certain other precisely defined transactions (distance sales, new means of transport), VAT continued to be chargeable under the resulting system in the Member State of destination or consumption.

At the same time, however, both legally and politically, the Council reaffirmed its April 1967 commitment to introducing a “definitive system” of taxation by which goods and services would be taxed in “the Member State of origin”.

1.3. The Work Programme for 1996

Once again, therefore, it fell to the Commission to put forward new proposals. In 1996 it presented a programme whose object was to introduce a single place of taxation for transactions within the Community, i.e. a trader’s “tax domicile”, and a macro-economic mechanism for redistributing VAT receipts between the Member States.

The plan envisaged a gradual changeover towards a definitive system. The first stage was to be modernisation and more uniform application of the existing system, accompanied by changes whose outcome would be a definitive system.

But it proved to be as difficult to implement this gradual approach as to effect what was known as the “big bang” of 1987. This was, *inter alia*, because gradual introduction raised problems of consistency as any new initiatives still had to be fitted into the existing system whilst already reflecting the principles of the definitive system.

The proposal for a directive determining the person liable for payment of value added tax,¹ presented by the Commission in November 1998, is a typical example of these difficulties.

It enunciated the general principle that a taxable person carrying out a taxable transaction should be liable for the tax that was due, whether or not that person was established in the country concerned.

Then, as well as dropping the tax representative, the proposal provided for ending the related option of designating the recipient of goods or services as the person liable for the tax (the reverse charge mechanism).

This was consistent with the logic of gradual progress towards a definitive tax system but, under the existing system, eliminating the reverse charge mechanism meant additional difficulties for traders engaged in cross-frontier activities, whom the arrangement exempted from VAT obligations in the Member State in which the transaction concerned was taxed.

The directive finally adopted by the Council – which did not in any case have the political will to bring in a definitive system in the short term – gives the Member States the option of requiring traders to designate a tax representative whilst nevertheless retaining the possibility of their using the reverse charge mechanism.

In practice, once the directive began to be implemented, the Member States even expanded the use of reverse charging.

But within a few years the Commission had to accept that, given the positions of the Member States on the 1996 programme, the latter was unrealisable.

On the one hand, if the existing system was to function more smoothly, changes were becoming increasingly necessary but, on the other, the Commission’s 1996 programme did not cater for proposals embodying change.

1.4. The “new” VAT strategy presented in 2000

In June 2000 the Commission presented a communication to the Council and the European Parliament in which it set out its strategic programme for improving the

¹ COM(98) 660 final of 27.11.1998.

operation of the VAT system in the short term.² This was the launch of the “New Strategy for VAT”.

The communication set out a pragmatic programme with four main objectives, namely the simplification and modernisation of current rules, more uniform application of the current rules and closer administrative cooperation.

At the same time the concept of a definitive system of taxation in the Member State of origin was retained as a long-term Community objective.

The programme presented in 2000 differed from the “definitive system” of the 1996 programme, with its firm timetable and short deadlines, in that the 2000 programme was much more flexible.

It provided for adopting proposals already before the Council and presenting others on which preparatory work was well advanced.

But it made no mention of specific programmes for subsequent years. The Commission simply touched on a number of topics it considered as meriting detailed examination. This meant that action could be focused primarily on those areas the Member States and traders considered most problematic.

With this pragmatic approach the Commission’s intention was to give new momentum to the Council and encourage it to adopt some of the specific, much needed improvements to the existing VAT system in the near future.

2. THE NEW STRATEGY: A PRELIMINARY REVIEW

On 20 October 2003 the Commission presented a further communication entitled “Review and update of VAT strategy priorities”³ which was a preliminary report on the progress made under the new strategy.

This showed that between June 2000 (when the new strategy was launched) and October 2003 the Council had adopted nine proposals on VAT-related matters.

Since that communication the Council has adopted two new directives, that on conferment of implementing powers and the procedure for adopting derogations⁴ and that to extend the facility allowing Member States to apply reduced rates of VAT to certain labour-intensive services.⁵

Although not all the measures are equally important it has to be recognised that, in an area where a unanimous Council decision is still required, the new strategy has been relatively successful.

² COM(2000) 348 final of 7.6.2000.

³ COM(2003) 614 final of 20.10.2003.

⁴ Council Directive 2004/7/EC of 10.2.2004 (OJ L 52 of 21.2.2004).

⁵ Council Directive 2004/15/EC of 10.2.2004 (OJ L 52 of 21.2.2004).

For a list of the directives that have been adopted readers are referred to the Annex, but the following are worth particular mention:

Elimination of the tax representative

As from 1 January 2003, the Directive on determining the person liable for tax⁶ removed the option previously open to Member States by which they could require intra-Community traders to designate representatives to handle matters relating to tax on any transactions those traders carried out in Member States other than the one where they were established.

Harmonisation of the content of invoices and acceptance of electronic invoicing

The Directive on invoicing⁷ created a legal framework by which electronic invoicing and the electronic storage of invoices was accepted and which established harmonised rules regarding the content of VAT invoices, the outsourcing of invoicing operations and self-billing.

E-commerce

In the area of international exports and Europe-wide sales the Directive on certain electronically supplied services⁸ has re-established a balance of competition between EU businesses and those not established in the EU.

Also, by adopting this Directive, the European Union is the first tax jurisdiction in the world to have developed and introduced a simplified framework for the payment of consumer taxes on e-commerce transactions in accordance with the principles agreed in the OECD.

Place of supply of gas and electricity

The process of liberalising the gas and electricity markets highlighted the difficulties of applying the VAT rules. The Directive on the rules governing the place of supply of gas and electricity⁹ is aimed at operations between traders active in these sectors and at ensuring that the place of taxation is the same as the place where the energy is consumed.

Administrative cooperation between Member States

Here there has been major progress, particularly since adoption of the Directive on mutual assistance for the recovery of claims¹⁰ and the Regulation aimed at providing a

⁶ Council Directive 2000/65/EC of 17.10.2000 (OJ L 269 of 21.10.2000).

⁷ Council Directive 2001/115/EC of 20.12.2001, (OJ L 15 of 17.1.2002).

⁸ Council Directive 2002/38/EC of 7.5.2002 (OJ L 128 of 15.5.2002).

⁹ Council Directive 2003/92/EC of 7.10.2003 (OJ L 260 of 11.10.2003, p. 8).

¹⁰ Council Directive 2001/44/EC of 15.6.2001 (OJ L 175 of 28.6.2001).

single legal instrument covering all aspects of administrative cooperation in the field of value added tax.¹¹

3. THE NEW STRATEGY: NEXT STEPS

In its communication "Review and update of VAT strategy priorities", the Commission also presents the initiatives it envisages in the short term.

It will continue to work towards a consistent approach in two general areas, i.e. reaffirming the principle of taxation at the place of consumption, and simplifying traders' obligations.

Taxation at the place of consumption and consistency with the definitive system

In effect, the first guideline repeats the fundamental principle that VAT is a general tax on consumption, with the revenue going to the Member State where actual consumption takes place.

Under the existing VAT system, the system itself assigns the tax to the Member State where final consumption of goods or services is deemed to occur. In practice, this means that rules governing the place of taxable transactions are so devised as to ensure that the tax goes to the Member State of consumption.

However, it has to be said that the rules on the place where services are provided, which were first drawn up in the seventies, serve less and less well to ensure that the objective of assigning revenue is achieved.

In practice, in the case of remotely provided services (e-commerce), firms providing such services often choose their place of establishment mainly for tax-planning reasons.

We therefore need to take another look at the rules on the place of transaction in order to ensure that, as far as possible, the place of taxation and the place of actual consumption are the same, subject to ensuring that the new rules do not impose excessive tax obligations on traders.

One frequently asked question is whether this approach is consistent with the principles of a system of taxing goods and services at the place of origin (this still being the long-term objective).

To answer this we must bear in mind the fundamental differences between the existing system and the definitive system.

In the origin-based taxation system envisaged by the Commission in 1996 the rules regarding the place of taxation merely identify the Member State to which the taxable person must pay the tax. It is then up to the system that re-assigns VAT revenue to ensure that each Member State receives the appropriate revenue.

¹¹ Council Regulation (EC) No 1798/2003 of 7 October 2003 (OJ L 264 of 15.10.2003, p. 1).

The tax is collected by a given Member State when taxable persons pay their VAT to the treasury, regardless of whether actual consumption takes place locally and, therefore, of the final amount to which a Member State is ultimately entitled.

As pointed out earlier, this differs from the present system in that, to ensure that the revenue goes to the Member State of consumption, transactions need to be taxed at a point as close as possible to the place of destination (the consumer) rather than at the place of origin (the supplier).

Past experience (see comments in point 1.3 on the directive determining the person liable for tax) shows that compliance with the differing principles of two different systems is impossible, particularly when it comes to assigning tax revenues (place of taxation) and paying tax.

Simplifying tax obligations – The one-stop shop mechanism

For B2B (business to business) transactions between taxable persons, making the business customer the taxable person (reverse charge mechanism) means taxation occurs at the place of consumption and the supplier does not acquire tax obligations in the Member State of consumption. We therefore need to look at a broader application of this mechanism to cover cases where the taxable person carrying out the transaction is not established in the Member State of taxation.

For business to consumer (B2C) transactions, where the customer is generally a private individual, taxation at the place of consumption currently means that traders have to be identified, and make returns and payments, in every Member State where they carry out taxable transactions.

Here it should be noted that the special mechanism for electronically provided services represents an important step in the operation of the common VAT system. Here, for the first time, the Council has accepted the principle that the Member State where a transaction is taxed need not necessarily be the Member State in which the VAT obligations relating to the transaction have to be fulfilled.

In the interests of simplifying those obligations, the Council has adopted the principle of a single place where a trader not established in the EU is identified, lodges his tax returns and pays VAT on all services provided electronically to persons established in the EU and not liable for tax (the one-stop shop).

There is no reason why Community traders in a comparable position (liable for tax in one or more Member States where they are not established) should not benefit from this simplification.

The 2003 communication advocates wider use of the one-stop shop mechanism as a key to simplifying the obligations of Community traders.

It should be pointed out that the future one-stop shop need not necessarily work the same way as the recently introduced mechanism for electronically supplied services. Apart from anything else, in the Directive which covers electronically supplied services, the Council imposed the condition that any mechanism for e-commerce must be capable of calculating the amount of VAT, handling VAT returns and collecting and assigning VAT revenue. The Council has to review the mechanism by 30 June 2006.

The Commission has indicated its intention of not limiting this review to electronically supplied services alone, but of widening it to all operations for which a trader is liable for tax in a Member State where he is not established. This would greatly extend the area of application of the one-stop shop.

In this connection it is interesting to note that a very similar system, the "Streamlined Sales Tax Project" (SSTP),¹² is under way in the United States.

Although the "sales and use taxes" charged in the United States are very different from the value added system of the European Union, it has been noted that similar problems arise in both and that the proposed solutions are comparable.

For instance, in the United States – mainly thanks to the possibilities opened up by the Internet – there has been a big expansion in the type of operation known in Europe as distance sales. In the United States these transactions cause considerable tax collection problems since a vendor not established in a given State cannot be designated as liable for the tax in that State. The party liable for the tax is therefore the end consumer, who usually omits paying the tax.

In 1967 the Supreme Court decided that a State may not require tax to be collected from a mail order vendor not physically present in that State. The Court confirmed this position in 1992, indicating at the same time that it would not be possible to designate a non-established vendor as liable for the tax unless the States simplified and standardised their tax system.

The SSTP is currently going into this possibility, the aim being to ensure that taxation takes place at the point of consumption and is collected from the taxable vendor. To fulfil the criteria laid down by the Court, consideration is being given to the possibility of setting up an electronic system that will enable a vendor to pay the taxes due in the various States where his customers are established. The features of this system are very similar to those of the one-stop shop (e.g. a single place of identification and for lodging tax returns). It would therefore be in the European Union's interests to monitor developments in this United States project.

4. THE GUIDELINES AS APPLIED IN PRACTICE

In the light of the guidelines set out earlier, four types of cross-frontier transactions should be examined.

B2B supply of goods

Exempting such supplies in the Member State of departure and taxing the intra-Community acquisition thereof in the Member State of destination, where the tax is paid by means of the regular returns, poses no particular problems.

B2C supply of goods

¹² See <http://www.streamlinedsalestax.org>

When the Single Market came into being on 1 January 1993 special arrangements were incorporated into the common VAT system to provide for taxing intra-Community sales of new means of transport, intra-Community sales to exempt taxable persons or non-taxable legal persons and distance sales at destination.

Nothing has occurred to alter the main reason for introducing these special arrangements, i.e. the risk of insufficiently harmonised tax rates leading to distortion of competition. Dropping the special arrangements is therefore not a realistic option.

But distance selling is a typical area in which the one-stop shop could bring substantial simplifications for traders established in the Community.

The B2B supply of services

On 23 December 2003 the Commission presented a proposal for a directive on the place of supply of services.¹³ The key element of this proposal, which covers B2B transactions only, is an amendment of the general rule by which the place where the customer is established would be substituted for the place where the supplier is established or has a fixed establishment. However, to avoid placing a disproportionate administrative burden on some traders, there would be exceptions to this general rule for some services on which there are currently no specific rules (e.g. services related to immovable property and transport services).

The amendment does not impose any additional tax obligations since the customer would pay the VAT by means of the reverse charge mechanism.

B2C supply of services

The current general rule for B2C transactions, i.e. that the service is taxed at the place where the supplier is established, is very simple for traders. However, when services can be provided remotely, this rule no longer guarantees that the tax receipts will go to the Member State in which the service is consumed and, increasingly, results in distortion of competition.

We therefore need to re-examine the rules on the place of taxation of services provided to end consumers. Any revision should guarantee that the principle of taxation at the place of consumption is applied more strictly.

But this must not result in traders bearing a significantly increased administrative burden, it being possible to prevent the latter by applying the one-stop shop mechanism to remotely provided B2C services.

In the amendment to the place of taxation of (B2C) services, the two guidelines on simplifying tax obligations (via the one-stop shop) and on taxation at the place of consumption are clearly and indissolubly linked.

The Commission plans to present the proposal on the place of taxation of B2C services in 2005.

¹³ COM(2003)822 final of 23.12.2003.

5. OTHER TOPICS COVERED BY THE NEW STRATEGY

Clearly revision of the rules on the place of taxation is not the only topic tackled by the new strategy. With a view to modernisation and more uniform application of the system several proposals for directives have already been presented to the Council and the presentation of more in 2004 is being considered. These are all included in the annexed Table but particular mention should be made of the following measures:

Proposals before the Council

VAT rates

The Commission presented its proposal¹⁴ on the area of application of reduced VAT rates with a view to simplifying the rules governing rates of tax and guaranteeing the more uniform application of the tax. The proposal aims to give Member States equal opportunities to apply reduced VAT rates in certain areas (such as restaurants, housing, gas and electricity supplies and home care services). It also aims to rationalise the numerous derogations currently applicable to VAT rates in some Member States. What is proposed, therefore, is to make Annex H the only reference for any derogation from the standard rate of VAT, the aim being to make the Internal Market work more smoothly and to avoid potential distortion of competition.

However, as this is a politically highly sensitive matter, it was unlikely that the Council would be able to reach agreement on it before the end of 2003.

Hence, to avoid any legal uncertainty as from 1 January 2004, the Council decided to allow nine Member States that already applied a reduced rate of VAT to highly labour-intensive services to continue doing so for a further two years, subject to the current conditions and without changing or widening the area to which these experimental rates applied. This will give the Council the time it needs to legislate on the proposal regarding reduced rates of VAT.

Special rules for travel agencies

The proposal for a directive aims to amend the VAT rules applicable to travel agencies that sell package tours to destinations in the European Union. The current special arrangement allows travel agents to apply VAT to their profit margins rather than to the full value of their sales. The proposal aims to change the rules to eliminate problems of double taxation which currently arise when one travel agency deals with another. It will also put a stop to the benefits of unfair competition accruing to some travel agents because the current rules are not uniformly applied in all Member States and because non-EU operators do not charge VAT on the package tours they sell to EU residents.

Arrangement for the postal sector

The Commission also presented a proposal to apply VAT to all services provided in the postal sector¹⁵ in order to take changes in the sector into account. When the Sixth

¹⁴ COM(2003)397 final of 23.7.2003.

¹⁵ COM(2003)234 final of 5.5.2003.

Directive was adopted in the seventies, the postal sector was in a monopoly position and provided a limited range of services for which there was no competition.

The aim of the proposal is to eliminate the distortions of competition currently causing difficulties for both the conventional national providers of postal services, who are currently exempt from VAT, and for their competitors, who are required to apply VAT. Market liberalisation is likely to increase these distortions. The proposed changes should not have a big impact on the cost of postal services to the general public since, for the first time, national operators will be able to deduct the VAT they themselves are required to pay on their costs - which they currently recover from their customers in the form of a hidden VAT charge. Also, to prevent any rise in the prices charged to the general public, Member States will be able to apply a reduced VAT rate to ordinary postal services (addressed consignments not exceeding a maximum 2 kg). And, where business customers are concerned, the VAT applicable to postal services provided by national operators will bring the benefit that the business customer will be able to deduct the tax from his expenditure on postal services.

Proposals planned for 2004

Recasting of the Sixth VAT Directive

The Sixth Directive is the legal framework for the currently applicable common VAT system. The Directive has undergone 20 legislative amendments since it first entered into force and the result is a legal instrument that is complicated and difficult to consult.

The Commission undertook to prepare a reworked version of the Directive to turn it into an effective instrument which clearly sets out the legislation currently in force.

The public was consulted on the exercise via the Internet, thus giving those involved an insight into the structure of the directive due to replace the Sixth Directive.

Simplifying VAT obligations

Also in 2004, the Commission envisages the introduction of a proposal for a directive simplifying traders' obligations. Here the one-stop shop will definitely be the most important component. However, the Commission is also considering including other simplifications for the application of the reverse-charge mechanism and the arrangement for distance sales.

Sales promotions using vouchers and payment cards

The tax treatment of vouchers, mainly used as part of sales promotion campaigns, has been the subject of a number of Court of Justice rulings in recent years.

A number of principles can be derived from these rulings relating to specific cases, but their application to the multiplicity of forms that promotion systems can take continues to pose considerable problems.

In addition, changes in the way certain goods and services are paid for, for instance payments by telephone cards, raises issues of interpretation regarding the point in time at which the tax becomes chargeable and the nature of the taxable amount for transactions conducted through intermediaries.

The introduction of a proposal for a directive to ensure more uniform treatment at Community level is envisaged in 2004.

Rationalising existing derogations

The Commission plans some rationalisation of the many derogations currently in force. In certain cases this could mean extending to all Member States the right to apply some of the derogations that have proved particularly effective.

Many of the existing derogations have certain features in common. For instance, there are similarities between the derogations several Member States apply to their respective gold and waste sectors.

On the other hand, it is clear that some measures are simply designed to remedy a particular situation in a single Member State. The rationalisation exercise does not intend to call this type of authorisation into question.

Mechanism for eliminating double taxation in individual cases

In its Communication of October 2003 the Commission announced its intention of introducing a Community-level mechanism to resolve the problem of individual cases of double taxation. It will not be a case of introducing a procedure to resolve questions of differing interpretation of the Sixth Directive, but of one based on the procedure used in direct taxation. Bilateral double taxation agreements drafted on the basis of an OECD standard text provide for a mutual agreement procedure to eliminate double taxation. Experience has shown that simply getting the national authorities of the Member States concerned to discuss a case very often results in a settlement.

6. CONCLUSION

In the light of the foregoing, it may therefore be concluded that the pragmatic approach of the new strategy has achieved its main objective, namely to give the Council a new impetus on VAT. The projects in preparation show that the Commission intends to continue along the path entered in 2000.

However, some of the proposals before the Council and some of the initiatives in the pipeline concern key parts of the VAT system which directly affect VAT receipts. Chief among these are the place of taxation, the assessment base and VAT rates and these will probably require longer and more difficult negotiations.

Similarly, the fact that the principle of unanimity has been retained in connection with taxation in the enlarged European Union will not facilitate the search for compromise.

The challenge currently facing the Commission and the Council is therefore to maintain the current momentum.

Proposals adopted since the new strategy was launched in June 2000

| Subject of the proposal | Stage reached in Council |
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| Determination of the person liable for payment of value added tax [COM(1998) 660] | Adopted by Council Directive 2000/65/EC of 17.10.2000 (OJ L 269 of 21.10.2000) |
| Greater mutual assistance for the recovery of claims [COM(1998) 364] | Adopted by Council Directive 2001/44/EC of 15.6.2001 (OJ L 175 of 28.6.2001) |
| Fixing the minimum standard VAT rate [COM(2000) 537] | Adopted by Council Directive 2001/41/EC of 19.1.2001 (OJ L 22 of 24.1.2001) |
| Invoicing [COM(2000) 650] | Adopted by Council Directive 2001/115/EC of 20.12.2001 (OJ L 15 of 17.1.2002) |
| Extending the Fiscalis programme [COM(2002) 10] | Adopted by Decision No 2235/2002/EC of the European Parliament and of the Council of 3.12.2002 (OJ L 341 of 17.12.2002) |
| Electronically supplied services [COM(2000) 349] | Adopted by Council Directive 2002/38/EC and Council Regulation (EC) No 792/2002 of 7.5.2002 (OJ L 128 of 15.5.2002) |
| administrative cooperation in the field of value added tax [COM(2001) 294] | Adopted by Council Regulation (EC) No 1798/2003 of 7.10.2003 (OJ L 264 of 15.10.2003) |
| Extending the facility allowing Member States to apply reduced rates of VAT to certain labour-intensive services [COM(2002) 525] | Adopted by Council Directive 2002/92/EC of 3.12.2002 (OJ L 331 of 7.12.2002), the corrigendum of 23.1.2003 (OJ L 18 of 23.1.2003) and Council Directive 2004/15/EC of 10.2.2004 (JO L 52 of 21.2.2004) |
| Place of supply of gas and electricity [COM(2002) 688] | Adopted by Council Directive 2003/92/EC of 7.10.2003 (OJ L 260 of 11.10.2003) |
| Conferral of implementing powers and the procedure for adopting derogations [COM(2003) 335] | Adopted by Council Directive 2004/7/EC of 20.1.2004 (OJ L 27 of 30.1.2004) |

Proposals still before the Council

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| Rules of Procedure of the VAT Committee [COM(97)349] |
| Right to deduct [COM(1998) 377] |
| Special scheme for travel agents [COM(2002) 64] |
| Services provided in the postal sector [COM(2003) 234] |
| The scope of reduced rates [COM(2003) 397] |
| Place of taxation of (B2B) services |

Proposals for legislation that the Commission envisages presenting in 2004

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| Recast version of the Sixth Directive |
| Rationalisation of measures granting derogations |
| Promotion systems and payment cards |
| Simplification of obligations (including revision of the rules on place of taxation of goods) |
| Eliminating the double taxation of private individuals |
| Implementing measures for Article 29a of the Sixth VAT Directive |