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 Second edition of a briefing originally drafted by Ana Claudia Alfieri.
 The 'EU Legislation in Progress' briefings are updated at key stages throughout the legislative procedure.
 Please note this document has been designed for on-line viewing.

More flexible VAT rates

Value added tax (VAT) is an important source of revenue for national governments and the European Union (EU) budget and, from an economic point of view, a very efficient consumption tax. However, the rules governing value added tax as applied to intra-Community trade are 25 years old and the current common EU VAT system is both complicated and vulnerable to fraud. Businesses doing cross-border trade face high compliance costs and the administrative burden of national tax administrations is also excessive.

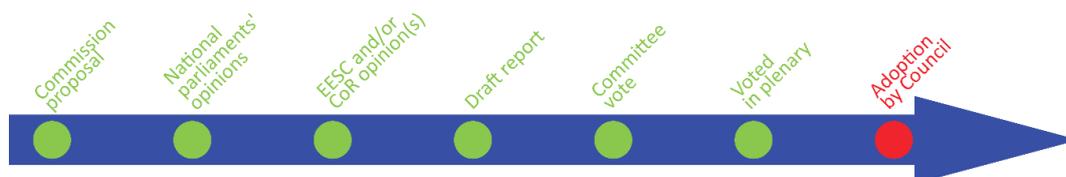
The reform towards the definitive system is planned in several consecutive steps and will take some years. In the meantime, this proposal will amend the VAT Directive (Directive 2006/112/EC) and reform the rules by which Member States set VAT rates. The reform will enter into force when the definitive system is in place; it will give more flexibility to Member States to set VAT rates and will end the current arrangements and their many ad-hoc derogations.

Parliament has adopted its non-binding opinion on the proposal, which is now in the hands of the Council.

Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax

[COM\(2018\) 20](#), 18.1.2018, [2018/0005\(CNS\)](#), Consultation procedure (CNS) – Parliament adopts only a non-binding opinion

Committee responsible:	Economic and Monetary Affairs (ECON)
Rapporteur:	Tibor Szanyi (S&D, Hungary)
Shadow rapporteurs:	Werner Langen (EPP, Germany) Sander Loones (ECR, Belgium) Thierry Cornillet (ALDE, France) Miguel Viegas (GUE/NGL, Portugal) Molly Scott Cato (Greens/EFA, United Kingdom)
Next steps expected:	Adoption by Council



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Introduction

The European Commission is overhauling the common European value added tax (VAT) system and has prepared several packages of proposals to reform it.

The origin of the current system is [the 1967 agreement](#), made by the members of the then European Economic Community (EC), to replace all turnover taxes with VAT and to have a common value added tax system. In addition, the agreement made use of VAT a precondition for accession for all new Member States.

The second milestone in the building of the current system was [the abolition of fiscal frontiers](#), which entered into force in 1993 with the creation of the internal market, and the amendment of the European Union's VAT system, which was set up as a transitional system. This is now 25 years old and needs to be modernised.

[The action plan on VAT](#), launched in April 2016, aims to adapt VAT to today's economy in a gradual way; one of its objectives is to establish a definitive VAT system.¹

[This proposal](#) has been submitted in that context and seeks to establish a common framework for setting VAT rates, granting Member States more flexibility and eliminating derogations. It deals notably with reduced rates and exemptions.

Context

When the transitional system was established, Member States agreed that the definitive system should be based on **the origin principle**: taxation would occur at the rates and in accordance with the legislation of the country of origin. In such a system, VAT rates have to be harmonised in order to avoid market distortions. Therefore, [in October 1992](#), it was agreed to set a minimum standard VAT rate and a list of goods and services to which reduced rates and exemptions could be applied.

Reduced rates and exemptions applied by some Member States before 1 January 1991 were accepted, by way of derogation, only as part of the transitional arrangements. The intention was that these derogations would expire once the definitive system was adopted.

In the [Council conclusions of May 2012](#), Member States recognised that application of the origin principle was not politically achievable. This recognition was the first step on the way to a definitive VAT system based on **the destination principle**. In such a system, the supply of goods and services is taxed at the rate of the country of destination.

¹ The action plan on VAT includes other reforms beside this on VAT rates. Two proposals on e-commerce have already been adopted and more proposals regarding the definitive VAT system for business to business (B2B) cross border transactions and the taxation of SMEs are being examined.



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Under the destination principle, it is possible to allow for greater variation in VAT rates across the Union than under the origin principle; different VAT rates will not cause economic distortions nor give an incentive to firms to sell from low VAT rate countries. Therefore, Member States can enjoy more flexibility in setting rates without disturbing the internal market.²

In general, when setting rates, a country can both (a) set a standard rate that will apply to the majority of products, and (b) apply reduced rates and exemptions, with the right of deduction, to a restricted set of products. The existence of several rates and exemptions creates a more complicated VAT system. As a result, national administrations face a greater burden when it comes to collecting taxes and controlling fraud, while firms face higher compliance costs.

Exemptions on final sales can be of two types:

- > exemptions [with the right of deduction](#), also called zero-rating, where a firm does not charge VAT on its sales but still can deduct VAT paid on the inputs it bought; the authorities do not collect any VAT on the chain related to these operations;
- > exemptions [without the right to deduction](#), in which the firm does not charge VAT on its sales and cannot deduct VAT paid on inputs; the authorities collect the VAT paid on inputs from the firm's provider.

Existing situation

The current common VAT system is a transitional system governed mainly by three pieces of legislation:

- > Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax ([the VAT Directive](#)),
- > Council Regulation (EU) No 904/2010 of 7 October 2010 on administrative cooperation and combating fraud in the field of value added tax ([the VAT Administrative Cooperation Regulation](#)), and
- > Council Implementing Regulation (EU) No 282/2011 of 15 March 2011 laying down implementing measures for Directive 2006/112/EC on the common system of value added tax ([the VAT Implementing Regulation](#)).

Member States are obliged to set a minimum standard rate at 15 % (Article 97, VAT Directive). This transitory provision had been being renewed every few years since 1996 and was made permanent by [the recent adoption](#) of [Council Directive \(EU\) 2018/912](#). In addition, Member States can apply one or two reduced rates, but only to the supplies of goods or services listed in [Annex III of the VAT Directive](#). The reduced rates cannot be less than 5 %. (Articles 98 and 99, VAT Directive).

² See [impact assessment accompanying the Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax \(SWD\(2018\) 7\)](#).

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Reduced rates have to be used 'for clearly defined social reasons and for the benefit of the final consumer'. The reduced rates can also apply to the import of works of art, collector's items and antiques, which are now under the special margin scheme.³

Reduced rates under 5 % and exemptions with deductibility of VAT paid at the preceding stage are only allowed by way of derogation, and are listed in Chapter 4 of Title VIII.

Parliament's starting position

In its resolutions [The future of VAT](#) (13 October 2011), [Modernisation of VAT legislation in order to boost the digital single market](#) (17 November 2011) and [Towards a definitive VAT system and fighting VAT fraud](#) (24 November 2016), the European Parliament noted that a VAT system based on the origin principle lacked the political support of Member States, and that it was therefore time to move towards a system based on the destination principle. Nevertheless, it found it desirable to narrow the rate variation between countries and took the view that the system should be simplified by reducing the number of exemptions, to reduce both uncertainty for businesses and opportunities for VAT fraud. It also favoured a broad-based VAT system that would respect the principle of neutrality, with exemptions granted on grounds of efficiency and social interest, for example to promote green energy or strengthen civil society. Member States should be granted more flexibility if that did not cause a permanent distortion of competition or interfere in the functioning of the single market.

Council starting position

Already in [March 2009](#), the Council allowed the possibility for Member States to apply 'reduced VAT rates in certain sectors', but it recommended considering other, more efficient alternatives. In its [conclusions on the future of VAT in general](#), in May 2012, it took note that the Commission favoured 'a restricted use of reduced rates in order to increase the efficiency of the VAT system'. In its [conclusions](#) of May 2016, it welcomed the Commission's intention to give more freedom to Member States in setting rates. One reason given was that more flexibility regarding reduced VAT rates would allow for VAT zero-rating for sanitary products. However, it stressed that 'a sufficient level of harmonisation in the EU remains required and the adopted solution has to be carefully balanced to avoid distortion of competition, a rise in business costs and a negative impact on the functioning of the single market'.

³ The **special margin scheme** applies to second-hand goods and also to works of art, collectors' items and antiques. The scheme is obligatory for Member States, but optional for businesses. It allows sellers of those goods to keep the same profit margin as in the standard case and consumers to pay less VAT than for purchase of a new item.



Proposal

Preparation of the proposal

The European Commission launched the debate to reform the common VAT system in 2010 with the green paper, [On the future of VAT – Towards a simpler, more robust and efficient VAT system](#), followed by [a consultation](#) that resulted in more than 1 700 contributions from national tax authorities, stakeholders and academia. These contributions fed into a second communication, [On the future of VAT – Towards a simpler, more robust and efficient VAT system tailored to the single market](#), which set out the desirable features of the definitive system and the priorities for the next years. The dialogue with Member States and stakeholders continued in the Group on the Future of VAT (GFV) and the VAT Expert Group (VEG). In April 2016, their work fed into the Commission communication, [On an action plan on VAT – Towards a single EU VAT area – Time to decide](#), which got positive feedback from the Council, the Parliament and the Economic and Social Committee. In view of the position of those institutions and after [a second public consultation](#) that lasted from 20 December 2016 to 20 March 2017, the Commission started the process of moving towards the definitive VAT system with several packages, the present proposal included.

The changes the proposal would bring

The proposal changes Article 98 so that Member States will be allowed to apply a maximum of two reduced rates not lower than 5 %. In addition, they may apply, by way of derogation, 1) a reduced rate potentially lower than 5%, and 2) an exemption where VAT paid at the preceding stage can be deducted (zero-rating). Moreover, it replaces Annex III, which contains the list of goods and services that can benefit from a reduced rate, with a new annex IIIa. The new annex will contain a 'negative' list of goods and services to which reduced rates will not be allowed, such as tobacco, alcohol, fuels and weapons. The European Commission will revise the list every five years, starting in 2026. The proposal deletes Article 99 and inserts an article 99a, which provides that the weighted average rate in a Member State at any given time must be higher than 12 %.

Articles 101, 102 and 103, which were connected to the functioning of the old annex III, are therefore deleted. The exception allowing for reduced VAT rates on the supply of natural gas, electricity or district heating is maintained, as those items are not included in the new annex IIIa. However, deletion of Article 103 signifies that reduced rates can only be applied to goods which are not classified as work of arts under the CPA (classification of products by activity) codes of annex IIIa.⁴ As Article 103 is deleted, Article 316(1) (c), which concerned works of art receiving reduced rates under Article 103, is also deleted. Two more derogations are deleted from Article 378(2)(b) and Article 387(c), which concerned VAT deductibility paid at the preceding stage of international passenger transport operations, respectively carried out by air, sea or inland waterways (except transport operations on Lake Constance) in Austria, and of inland passenger transport, international passenger transport and domestic inter-island sea passenger transport in Malta.

4 Objects listed in points (5), (6) and (7) of Annex IX, Part A need not be considered as works of art for the purposes of the special arrangements for supplies under the margin scheme and by public auction, if Member States have taken up the option under Article 311(2).



Preparation of the proposal

The changes the proposal would bring

The proposal deletes Article 104a which allowed Cyprus to apply one or two reduced rates to the supply of liquid petroleum gas (LPG) in cylinders. It also changes Article 105, so Portugal can continue to have lower VAT rates applied to transactions taking place in or for direct imports into the Azores and Madeira, but from now on that standard rate in those territories cannot be lower than 15 %. At the same time Article 105(1) allowing for reduced rates on bridges in the Lisbon area is deleted but as that service is not one of the goods or services listed under annex IIIa, it can still continue to benefit from reduced rates under the constraints of the amended Article 98 and new Article 99a. Finally, the proposal repeals the transitional provisions of Chapter 4 of Title VIII, which compile all the existing derogations from the general rules.

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Views

Advisory committees

In its [opinion on the action plan on VAT](#), delivered on 13 July 2016, the European Economic and Social Committee (EESC) noted that it would like to see the implementation of the definitive VAT system 'within a reasonable time-frame' and supported the new system being based on the destination principle. It described the desirable features of a system of VAT rates: flexibility, legal certainty, simplicity and transparency. Simplicity, in turn, implies a small number of reduced rates and exemptions.

The work on the present proposal was carried out under the [VAT reform package \(II\)](#) by a dedicated study group of six members, including the rapporteur Petru Sorin Dandea and the president Krister Andersson. In the resulting [opinion](#), adopted during the plenary session of 23 May 2018, the EESC welcomed the Commission's proposal, agreed with its main points and recommended its rapid adoption. It underscored that reduced rates had to benefit the final consumer. Moreover, it stressed that Member States had to enjoy the freedom to set both reduced rates for certain general-interest goods and exemptions for organisations that provide services for disadvantaged people. The EESC was of the opinion that Member States should reinforce their national tax administrations with more human, financial and logistical resources to be able to fight VAT fraud. Finally, it encourages Member States 'to adopt the definitive VAT system within a reasonable period of time'.

National parliaments

The [subsidiarity deadline](#) for national parliaments to submit comments on the proposals was 20 March 2018. The proposal was examined by the German Bundesrat, the Spanish Cortes Generales, the Portuguese Assembleia da República and the Czech and Romanian Senates and no reasoned opinion was issued. Only the Bundesrat and the Romanian Senate made additional contributions.

The [Bundesrat](#) considers that the proposal goes against the objectives of the common VAT system, as it will raise compliance costs, not only in cross border sales but also at domestic level. It underscores that in the definitive system – based on the destination principle and with more cooperation between national administrations – there should be a higher degree of harmonisation and that the rules regarding tax rates should be made simpler and more uniform.

The [Romanian Senate](#) requests clarification on the obligation for Member States to ensure that the weighted average of VAT rates is at no time below 12 %, as this may oblige some countries to revise or eliminate reduced VAT rates in force.



Advisory committees

National parliaments

Stakeholders' views

Stakeholders' views⁵

To date, no major stakeholder has presented its position on the Commission proposal.

⁵ This section aims to provide a flavour of the debate and is not intended to be an exhaustive account of all different views on the proposal. Additional information can be found in related publications listed under 'EP supporting analysis'.



Legislative process

In the **European Parliament**, the proposal follows the consultation procedure. It was assigned to the Economic and Monetary Affairs Committee (ECON) (Rapporteur: Tibor Szanyi, S&D, Hungary). The Legal Affairs Committee (JURI) decided not to give an opinion.

The draft report was discussed in the ECON committee and voted in committee in September 2018. The [report](#), adopted in committee and tabled for plenary, suggested the following changes to the Commission's proposal:

- > Introducing a maximum rate of 25 % for the minimum standard rate of 15 %
- > Adding, for reduced rates, that priority shall be given to goods and services having positive impacts on the general interest, such as goods having cultural, social or environmental benefits.
- > Introducing a procedure whereby the Commission would be empowered to enact modifications of annex IIIa by means of an implementing act, provided there is evidence related to distortion of competition which justifies the update.
- > Modifying the provision related to the reporting on annex IIIa. The Commission should submit a report every two years instead of every five, to both the European Parliament and Council on the scope of annex IIIa. The Commission proposal only requires submission of a report to the Council.
- > Introducing a provision which would require the Commission to establish, in cooperation with Member States, a comprehensive, multilingual and publicly accessible Union VAT web information service, in order to provide accurate and effective information to consumers and businesses regarding VAT rates and VAT systems in the different Member States. This provision is particularly focused on facilitating intra-Community cross-border business activities of small and medium-sized enterprises.
- > The new annex IIIa as proposed by the Commission presents in its column A the product categories to which Member States cannot apply reduced VAT rates. Under column C of annex IIIa, the Commission has included items that are to be exempted from the prohibition to introduce reduced rates, despite belonging to the categories mentioned in A. The ECON committee report proposed to withdraw from column C of Annex IIIa the following item: *'Supply of motor cars and other motor vehicles principally designed for the transport of <10 persons, incl. station wagons and racing cars, other than those vehicles with spark-ignition engine only or with compression-ignition internal combustion piston engine (diesel or semi-diesel) only'*. The report also proposed the introduction of *'Pacemakers; hearing aids'* in column C of annex IIIa, thus proposing to allow the introduction of reduced rates on these items.

The European Parliament [resolution](#) was adopted in plenary on 3 October 2018. It proposes the same changes as those mentioned in the Committee report.

In the **Council**, the proposal is being examined at working party level where exchanges are taking place with the aim of reaching a presidency compromise text.



References

EP supporting Analysis

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