Simplifying and Modernising VAT in the Digital Single Market

STUDY

EN 2012
Abstract

E-commerce is a large and growing business and a key part in the digital economy. To reap the full potential, a number of barriers needs to addressed, not the least the obstacles that the current VAT system presents to cross-border sales of physical and in particular digital content e-commerce products.

This report lists shortcomings in the present VAT set-up, evaluates policy options put on the table by inter alia the European Commission and provides a range of recommended policy options that should be reviewed in more detail.
This document was requested by the European Parliament's Committee on Internal Market and Consumer Protection.

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LINGUISTIC VERSIONS
Original: EN

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Manuscript completed in September 2012.

This document is available on the Internet at:
http://www.europarl.europa.eu/studies

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LIST OF ABBREVIATIONS

**B2B**  Business to Business

**B2C**  Business to Consumer

**DG**  Directorate General

**EC**  European Commission

**ECB**  European Central Bank

**ECJ**  European Court of Justice

**EDI**  Electronic Data Interchange

**EU**  European Union

**GDP**  Gross Domestic Product

**IP**  Internet Protocol

**OECD**  Organisation for Economic Co-operation and Development

**OSS**  One-Stop-Shop

**SME**  Small and Medium Enterprises

**UK**  United Kingdom

**USO**  Universal Service Obligation

**USP**  Universal Service Provider

**VAN**  Value-Added Networks

**VAT**  Value Added Tax
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BACKGROUND AND AIM OF STUDY

In December 2010, the European Commission published a Green Paper on the future of VAT - towards a simpler, more robust and efficient VAT system. With this Green Paper, the Commission aimed at relaunching a debate on VAT. On October 13, 2011 European Parliament adopted the resolution on the future of VAT, focusing on VAT design, reducing red tape and, maximising efficiency of revenue collection. This resolution has been followed by the European Commission’s Communication of 6 December 2011 on the future of VAT.

The main issue of the current reform of VAT is the complexity and fragmentation of the current VAT system. Complex legal rules and administrative formalities make operation in the Single Market difficult, requiring significant resources to be employed by businesses and administrations, and lead to unpredictable outcomes due to potential mistakes and interpretative difficulties which may have significant financial consequences. At the same time, these complex rules do not guarantee efficacy in revenue collection whilst creating numerous competitiveness problems from the side of economic operators who engage in fraud, avoid VAT or illegitimately use reduced VAT regimes. Member States experience significant VAT gaps which exceed 30 per cent in some cases.

Issues stemming from the complexity of the current VAT system go to the heart of the Digital Single Market. At the same time, the Digital Single Market and e-commerce leading to the proliferation of easily traceable non-cash electronic transactions may significantly contribute to curbing fraud and tax avoidance as well as limiting shadow economy which pushes today's Europe into a budgetary crisis.

In this context, Committee on Internal Market and Consumer Protection has requested a research study on the "Possibilities and obstacles to simplifying and modernising VAT in the Digital Single Market for E-Commerce" with the aim of providing background information and advice for the Members of the IMCO Committee on priority measures and actions to be undertaken in this field.

The study is based on interviews, existing available data, specialised literature and expertise in the area. It offers a balanced picture of the variety of views considered among professionals in this field, as well as the contractor's independent assessment. The analysis is based on concrete figures and statistics and is complemented by illustrative examples.
EXECUTIVE SUMMARY

E-commerce continues to grow and change form at the same time. E-commerce is defined as both traditional sales of physical goods sold within and across borders facilitated by online ordering and payment systems ("distance selling") as well as online provision of "digital content services". For goods, the most important products are clothing, sporting goods, and paper publications; while digital content services are typically related to travel and holiday accommodation bought online, the download of music/games/videos, and electronic publications.

The size of the e-commerce economy is significant and increasing, accounting for over 5 per cent of GDP in a number of EU countries where access to internet and per capita income is high. Moreover, digital content services facilitated by rapid improvements in technology are particularly on the rise. Cloud computing where data and programmes storage is placed at external services, instead of using space on the consumer's own computer, is a case in point. This is arguably one the most international of e-commerce activities.

While e-commerce has the potential to increase EU welfare substantially, it also faces a number of regulatory barriers that block the realisation of this potential. Far from perfect VAT system accounts for a significant part of the obstacles.

The fundamental driver of problems is the differences in VAT rates within the EU. The differences exist in three dimensions. First, there are substantial differences between Member States in the VAT rates that they apply to the same types of typical e-commerce products. This provides, in some circumstances, an incentive for private consumers to source products from the country with the lowest VAT rate. Second, physical variants of products are in a number of cases taxed at lower rates than the digital variants within countries: a classic example is physical versus electronic books. This provides a VAT-induced incentive to choose the physical variants. It also creates the so called mixed supply problem: if two products with different VAT rates are sold by the same supplier to a customer: what VAT rate should apply? For instance, a consumer may acquire the right to both a hardcopy newsletter/magazine and access to an online softcopy version for a single price. Third, the VAT treatment that can apply to certain suppliers can provide the supplier with an advantage in the distribution or facilitation of the e-commerce trade: universal post service providers and certain payment facilitators may be able to apply VAT exemptions to their services, respectively, transporting physical goods and providing payment facilities.

The VAT system is evolving to deal with some of these challenges. First, for several years, suppliers of distance selling products have had to apply the VAT of the destination country when selling goods to other countries, if their sales exceeded certain thresholds. Second, for B2C digital content services provided by EU based business to customers resident in the EU, it was decided in 2008 to go from a country of origin to a country of destination system as of 2015 (such a rule has already been applied to non-EU based businesses operating in the EU since 2003).

Yet, shortcomings in the VAT treatment of e-commerce are substantial. While implementation rules for the conversion towards the destination principle for digital content services were adopted in 2011, they are too general in many cases as to offer the needed clarity on application of rules for traders and VAT authorities. As long as suppliers could apply the rules of origin, they basically only needed to know the tax rules of their own country.
Moreover, there are other challenges to the VAT system that are also highly relevant and should be considered in the context of reforming VAT treatment of e-commerce. This includes the general review of VAT rate policy initiated by the European Commission in the spring of 2012, the increased focus on VAT gaps – actual VAT revenues being reduced by tax evasion – and the high compliance burdens resulting from the present VAT system.

Indeed, as argued below, there is substantial scope for reducing both compliance costs for traders and reducing the VAT tax gap by improving VAT collection systems not the least by way of increased digitalisation of VAT compliance. E-commerce is a promising case as outlined below. The current economic climate with large budget deficits and a need to improve competitiveness provides a compelling reason to review such options thoroughly.

In this context, our review of options all falls into three areas:

- Priorities for EU VAT rate policy;
- The implementation of the destination principle for all B2C e-commerce;
- Compliance models for collection of revenues, reporting systems and quality of audits.

**VAT rate policy: what can and should be achieved?**

In spring 2012, the European Commission launched a new review of EU VAT rate policy and identified three priorities. These are to safeguard the internal market, underpin adopted EU policies inter alia in the areas of health and the environment and finally to insure like VAT treatment of like products and services.

We support these principles and discuss way to implement them over the coming years. We underline first of all that equal treatment of physical and digital version of like products should be priority number one in this context. The unequal treatment embodied in the current VAT directive (1) leads to distortions to the internal market, (2) limits the environmentally friendly advantages of digital goods vis-a-vis physical variants, and (3) distorts consumer choice. It also is at conflict with underlying objectives which have motivated the use of reduced rates on cultural or other merit-based products, namely to make such products (for example books), affordable for a wider population.

Equal treatment can be achieved either by standard rating of both physical and digital rating or by applying reduced rates to both variants.

In a solution with standard rating of both variants we argue that such a move would be much facilitated by broader VAT reforms that would allow for substantial reductions of the standard rate in many countries. This could help to avoid substantial increases in VAT rates on politically favoured objectives such as purchases of books, magazines etc.

However, there are also arguments for reducing rates on both variants. A key argument is the problems of enforcing the destination principle for digital content services in a global context. Indeed, over time there is a risk of “leakage” of digital content services to non-EU countries if EU VAT rates are substantially higher. Imagine that the EU was capable of achieving a uniform VAT system with standard rates in a relatively narrow band for all countries and eliminating the reduced VAT rates for products relevant for e-commerce. While this scenario is at present somewhat optimistic, it would also raise two challenges: (1) will the EU be capable of getting agreements with relevant external trade partners to set up systems where these partners impose destination-based VAT rates to 27 different Member States and (2) if (1) is completed, will payment patterns arise whereby EU consumers would use non-EU registered payment systems to carry out trade to save on VAT?
When considering this, one should bear in mind that the only evidence of a digital content service having taken place is "bits" transferred over the internet and a payment being cleared, also on the internet, mobile phone etc. Moreover, the system for exchange of information and co-operation is much deeper between EU Member States than between EU and even key trading partners.

Hence in addition to a move towards standard rating for both physical and digital e-commerce products, we suggest a review of another option. This option would be to go for reduced rate treatment of both digital service products and their physical variants, preferably at a common EU rate. This could be an interesting option in several dimensions. Many of the principle benefits are to be achieved, such as better functioning of the internal market and no tax bias favouring environmentally more friendly products while also ensuring like VAT treatment of like products.

As a point of departure it should lead to less tax revenues, but we would argue that in particular for the digital content service part, the revenue effects are uncertain. We have argued that enforcing standard rating on such a mobile tax base on a global scale will be a challenge. At the global level, VAT rates/sales taxes are well below EU rates providing an incentive to source products abroad. In the US, many states impose no taxes at all on digital services. At the same time, convincing the EU's trade partners to implement and enforce systems that oblige their national operators to adopt EU destination rate principles with all the complexities outlined above for the sole benefit of the Member States may prove an uphill struggle. So a lower and uniform rate would imply a lower incentive for customers to source from non-EU countries, while at the same time increase the likelihood of non-EU government and private sector co-operation in practice e.g. remitting VAT revenues due to EU Member States.

In addition to addressing differences in VAT rates on physical and digital variants, VAT policy towards media industries more broadly should be reviewed. Emerging and broader trends in the area of the public and private media and communication industries is increasingly challenging the effectiveness of reduced VAT rate to further such aims (reduced VAT rates for certain types of broadcasting is an example). Instead of VAT rate reductions applying to particular channels of communication (printed books, paper version of newspapers, television), specific support could be given to production of media content that serves identified public interest purposes.

Finally, we would call for more uniform and market neutral VAT treatment of e-commerce related services across the EU. Postal and financial serves as well as mixed supply issues have been identified as being particular problematic for the operators as well as distorting the functioning of the internal market.
Implementing the destination principle for B2C digital services

The move towards the destination principle for B2C digital services raises a number or problems. The following four identification issues are of key importance among them:

Who are you selling the service to? Knowing the tax status of the customer is crucial: if it is a VAT registered customer, a cross-border sale should be zero rated.\(^1\) If it is a cross-border sale to a non-VAT registered consumer, the VAT rate of the destination country is to be used. In this case, the supplier needs to know which country the buyer, from a VAT perspective, is residing in, which leads to the where question.

Where are you selling the service to? For distant sales (goods) the final shipment address is highly likely to be located in the residence country of the final customer, who wants the shirts or the books to be delivered to their home address or work place. For digital content services the story is more complex, essentially the product is sent to an IP address which can be located in any country and subsequently downloaded from there.

When are you selling the service? There may be a time distance between the payment for a service and the actual delivery, for example, in the case of prepaid vouchers that are often used to purchase on-line products. So when is the VAT due?

Moreover who bears the VAT liability for trade? We are increasingly seeing trade patterns with multiple suppliers involved in the trade: the underlying supplier of particular goods and services, the payment facilitator, telecommunication companies etc. The question ultimately is: who bears the responsibility for paying the VAT due in such a supply chain and who ensures that proper records are kept, etc.?

The EU has started to provide some guidelines in relation to some of these matters, such as the VAT Committee guidelines published in the summer of 2011 relating to the identification of the supplier when digital content is provided via telecom operating companies, and the Commission’s recent proposal as to when to charge VAT in case of vouchers or other pre-paid systems such as pre-paid phone cards, pre-credit payment, etc.

However, there is more work to be done as confirmed in public consultations and in a number of interviews carried out for this study.

Our first priority is to provide more clarity to traders and VAT authorities. This applies first of all about how the who, where, when and what questions are going to be applied in practice.

The European Commission has suggested that dissemination of information on VAT tax regimes in the area of e-commerce across EU should be supported by way of web portals. This is a helpful step to be recommended. To be effective the active involvement of stakeholders is required in order to make it useful and operational from the perspective of traders and national VAT authorities. It will not reduce complexity per se, but at least help traders understand rules in other countries.

However, in addition to that we suggest that Good Faith Guidelines are proposed by the European Commission to be subsequently adopted by Member States after close consultation by stakeholders. Such guidelines should establish which steps a trader should take to verify the identification along the four dimensions outlined above. Once this has been done correctly, the trader should be considered as having acted in good faith in subsequent audits. This should bring down compliance costs inter alia by allowing more ICT based systems with EU scale to define appropriate tax treatments, reducing the costly need

\(^1\) From a technical point of view, the cross-border supply of services rendered to a business customer established in a different country is considered as falling outside the territorial scope of VAT in the country of the supplier. As a result, no local VAT is due on the supply, and the customer will have to self-assess the VAT on the purchase.
for human intervention to conclude a trade. The appropriate legal base of such guidelines may need to be determined: the crucial issue is to provide as much certainty to traders as possible, reducing/eliminating the room for tax authorities to open tax cases against them if the Guidelines have been followed.

A second priority is to achieve consistent and non-distorting application of VAT rules across Member States. We have already noted that, for example, the application of the VAT exemption on financial services vis-a-vis payment facilitation is applied differently across the EU, sometimes distorting the choice of suppliers. Given the slow progress on the EU proposal that could help deliver clarification and modernisation of VAT treatment of the financial, more "soft" guidelines could push Member States towards practices that are non-distorting and uniform building. Both regards application of VAT to financial services as well as mixed supply situations, areas of the growing jurisprudence of the Court of Justice of the European Union.

A third priority is a guiding principle of proportionality. There needs to be a balance between protecting the interests of Member States and the compliance cost on traders. The fact that a very substantial part of e-commerce transactions is of low value, often with non-returning customers, suggests that the obligations on traders to verify the status of individual customers should not be too onerous in general. It is here that the Guidelines could prove very helpful in defining this balance clearly and consistently at the same level across the EU.

Collection systems

The EU VAT system provides a significant part of public revenues – 21 per cent in 2009 – but is also the cause of a high level of unnecessary compliance costs and tax avoidance. Of EUR 88 billion of total compliance cost, perhaps 67 billion is due to its complexity and differences between Member States complicating cross-border sales and more uniform operating procedures. As well, as much as 12 per cent of total VAT due is not actually paid, equivalent to a revenue loss of EUR 119 billion in 2009.

In our review of options for reform, we make a distinction between solutions ready for moving to destination rate principle in 2015 and more radical but also more complex solutions that may at best be ready by the end of this decade.

Reforms should aim at streamlining the whole process of reporting, payment and control flows between vendors and tax authorities. The present set-up implies that vendors need to report overall sales and due VAT revenues to destination countries’ tax authorities. Moreover, they are to keep records on a transaction-by-transaction basis that can be requested by these tax authorities, should the tax authority wish to challenge the vendors’ attribution of sales and tax revenues between tax jurisdictions. This imposes a heavy compliance burden on vendors going well beyond what they are typically required to do for domestic audit-related purposes; it also exposes vendors to risks of double taxation when different tax authorities disagree on the respective shares of revenues.

For the operation of the system from 2015, we have rolled out three basic sets of options, increasing in the level of ambition with respect to making life easier for businesses and tax authorities and in turn allowing more automated information exchange:

Option A takes as its basis the European Commission One-Stop-Shop proposal which allows cross-border e-commerce vendors the option of sending information about completed cross-border trades to the relevant (up to 27) tax authorities through just one tax authority and report. The option will still require that the vendor keeps records on a transaction basis that can be requested by the foreign authority.
We propose that this regime is complemented with an extension of the OSS to distant sellers and with simplified revenue not transaction based reporting (limiting reporting to just one country and with the same level of detail as for other retailers).

**Option B** goes one step further by proposing an OSS responsibility also for tax audits with either the chosen Member State of reporting or a cross-border team of coordinated auditors. This would reduce the need for vendors to exchange information with multiple countries’ tax authorities and would avoid conflicting viewpoints from such authorities leading to double taxation that the e-commerce vendor is only dealing with the domestic tax authority and has no direct bilateral relationships with other tax authorities. This option in particular should have substantial value for SMEs that can now engage in cross-border trade based on good faith guidelines referred above and being checked by local authorities as part of the standard compliance and audit checks.

**Option C** goes yet one step further by proposing that country of origin rules apply to the definition of mixed supply, the definition of digital content services etc. while destination country VAT rate would still apply. This would further reduce the need for firms to assess the rules in other Member States. This would in particular benefit SMEs.

**Our recommendation** is that the EU moves forward with joint implementation of all three options. Ultimately, it is a solution where individual e-commerce traders, whether of goods or digital services, only have formal relations with one national tax authority to whom they provide VAT payments and trading data when called for and which is responsible for audit controls. At the same time, this relationship is increasingly being made on the basis of uniform rules and procedures across the EU where the European Commission steps up its role as the guardian of the common market in line with the role outlined in recent VAT communications.

**For the functioning of VAT payment and collection systems beyond 2015** we recommend intensified use of ICT to improve effective tax collection i.e. reduce the substantial VAT gap and reduce compliance costs. Earlier analysis has shown that far-ranging solutions such as the split payment system and the limited data warehouse system may eliminate the bulk of the yearly VAT gap of EUR 119 billion at EU level at reasonable costs relative to revenue gains to be reaped cf. Figure 1.
Figure 1: Potential for closing the yearly VAT gap

Note: The VAT gap calculation is based on split payment and the “limited” data warehouse model, over period 2016 to 2038, EU27 estimates. The yearly VAT gap reduction is calculated very roughly as NPV divided by number of years with the system fully implemented in the model calculations which are from 2020 to 2038 i.e. 19 years.

Source: Copenhagen Economics based on PWC (2010), page 251-252

Thus, it could provide a sizeable contribution to the consolidation of public finances urgently needed in many EU countries. At the same time, there is also evidence that full implementation cannot credibly be made operational across the board within this decade. However, e-commerce is already effectively operating exclusively with digital payment systems. In this context, we propose that e-commerce could prove a very good test case for a more general implementation of such models.

We then recommend that two steps are taken now:

First, operators and authorities need to put into place systems for e-commerce that are workable from 2015. We recommend a package with all three options A, B and C above in addition to much stronger efforts of uniform implementation of VAT rules across the EU, with the legal instruments this require.

Second, start preparing a pilot project for e-commerce for intensified use of ICT system, building upon earlier analysis and recommendations such as the combined model with the split payment and the limited data warehouse system. This can then evolve into more general reforms later in the decade.
Table 1: Recommendation for VAT treatment of e-commerce

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<th>Policy option</th>
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<tr>
<td><strong>Setting VAT rates</strong></td>
<td>The thresholds for cross-border sales of goods that determine whether individual vendors are obliged to impose destination based VAT rates on their sales vary substantially between Member States. We propose that this should arguably be addressed by adopting common thresholds or at the very least a move towards more common threshold values.</td>
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<tr>
<td>1.1</td>
<td>Set more common thresholds for applying destination country VAT rates to distance selling</td>
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<td>1.2</td>
<td>Abolish the difference between physical and digital variants of a range of products relevant for e-commerce</td>
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<td>1.3</td>
<td>Review the advantages and disadvantages of such alternative scenarios where digital and physical variants are both taxed at either standard or reduced, preferable uniform, rates across the EU</td>
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<td>1.4</td>
<td>Review alternative mechanisms for serving the cultural and educational objectives that motivate the use of reduced rates for e-commerce related cultural and educational products and services</td>
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<tr>
<td>1.5</td>
<td>Ensure more uniform and market neutral VAT treatment of digital payment related services across the EU</td>
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We have reviewed two ways of doing this: a) Standard rating for basically all paper-based media outlets along with their digital variants, preferably in conjunction with wider VAT reforms. b) Reduced rates on both physical and digital content providers. This option is particularly relevant given the increasingly global nature of digital e-commerce trading.

Key issues to be analysed are: a) Potential losses resulting from reduced rates instead of standard rates given reduced “leakage” of particular digital content services to countries with low or zero sales taxes. b) Prospects for getting the necessary cooperation with trading partners to ensure the destination principle for taxation on digital content services on a reciprocal basis. c) Resulting effects on compliance costs under alternative scenarios for both rate setting and rules for collection, reporting and audit.

Current trends in the area of the media and communication industries are increasingly challenging the effectiveness of reduced VAT rate. Instead of VAT rate reductions applying to particular channels of communication (printed books, paper version of newspapers), specific support could be given to production of media content that serves identified public interest purposes.

Postal and financial services as well as mixed supply issues have been identified as being particularly problematic for the operators, distorting the functioning of the internal market. In want of “hard” legislation, relevant legislative proposals have been blocked in the negotiation process. Therefore, we believe that “softer” guidelines might push Member States towards practices that are non-distorting and uniform.
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<th>Policy option</th>
<th>Description and background</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Guidelines/codes for common interpretation of VAT concepts</td>
</tr>
<tr>
<td>2.1</td>
<td>Effective dissemination of operational information</td>
</tr>
<tr>
<td>2.2</td>
<td>Move towards the establishment of what the European Commission has termed a common VAT Code</td>
</tr>
<tr>
<td>2.3</td>
<td>Establishment of Good Faith Guidelines</td>
</tr>
<tr>
<td>3</td>
<td>Compliance models: next steps</td>
</tr>
<tr>
<td>3.1</td>
<td>For the operation of the system from 2015</td>
</tr>
<tr>
<td></td>
<td>Option A</td>
</tr>
<tr>
<td></td>
<td>Option B</td>
</tr>
<tr>
<td></td>
<td>Option C</td>
</tr>
<tr>
<td>3.2</td>
<td>For the functioning of VAT system further into the future</td>
</tr>
</tbody>
</table>

**Source:** Copenhagen Economics
1. E-COMMERCE TREND IN THE EU

To understand the importance of properly designed VAT systems in the context of e-commerce, we will provide in this chapter some basic facts about e-commerce. In section 1.1, we provide a basic definition of what is commonly meant by e-commerce. In section 1.2, we provide a very brief description of the basic characteristics which determine whether goods and services are likely to be traded by way of e-commerce. In section 1.3 we provide some stylised facts about current and expected trends in e-commerce, followed by section 1.4, outlining the development of e-commerce from a consumer perspective. Finally, section 1.5 provides for a summary of Chapter 1.

1.1. Standard definitions of e-commerce

The electronic processing and transmission of data, including text, sound, and video has allowed the emergence of electronic businesses. E-businesses might be defined as commercial activities performed over new technology platforms, which enable agents with the so-called "electronic commerce" or "e-commerce". This new form of business encompasses diverse activities, from the electronic trading of goods, services, and e-banking, via on-line delivery of digital content, collaborative design and engineering, public procurement, to direct consumer marketing. Therefore, electronic commerce has represented a revolution. The use of informatics, computers and networks enables new activities (e.g. virtual malls), as well as new provisions of traditional activities such as healthcare and education, but at the same time it represents new challenges.

Among those new challenges, the application of the VAT to e-commerce is considered to be one of the most significant.

Electronic commerce might be defined along two dimensions, namely (1) the nature of the item traded and (2) the character of the agents involved.

With respect to the nature of the item traded, the standard definition is split up into two main categories, namely:

- Distance selling, which refers to the electronic selling of tangible goods, which still must be physically delivered using traditional channels (i.e. postal services);
- Digital content services or direct electronic commerce, which concerns the on-line ordering, payment and delivery of intangible goods. As a principle, according to the European lawmaker and the OECD, such virtual goods are deemed to be electronically supplied services, so that the VAT rules to be applicable differ from those applied to traditional distance selling of goods.

In regard to the character of the agents involved, the classical distinction is between sales from:

- B2B (Business-to-Business)
  This refers to the commerce between companies covering all transactions within the supply chain, except the final sale to the end consumer;
- B2C (Business-to-Consumer)
  This term generally refers to businesses selling to the general public for their private use through any electronic platform (i.e. Internet).
To conclude, it is worth noting that electronic commerce is not just limited to the Internet. New technologies provide us with applications such as narrowband, broadcast, off-line devices, and networks which enable us to conduct new electronic businesses. Nevertheless, the Internet still represents the main tool to operate through, and it generates many innovative hybrid forms of electronic commerce; for instance, combining traditional marketing tools with Internet response mechanisms, or CD-ROM devices with Internet connection. Every day, new forms and functions are being created providing added value to businesses and consumers – i.e. the PCW (Price-comparison Webs).

1.2. **Main characteristics of e-commerce goods and services**

This section defines the characteristics of goods and services that give them a high degree of tradability, i.e. consumers will be inclined to purchase or source a large share of their purchase outside their own country if a given price bargain can be obtained.

From a traditional conception of distance selling (electronically conducted as well as non-electronically conducted trade) we define three characteristics as being the drivers of purchases in general and foreign sourcing in particular.

First, the 'price-per-kilo' is an issue, as the potential price gains from sourcing purchases outside the local mall/outside the resident country tend to be eaten up if transportation is costly relative to the price of the goods.

Second, even more so than for cross-border trade, long distance sales require that goods and services can endure transportation.

Third, distance sales are based upon the concept that customers have faith in the product as they cannot physically inspect them before purchase. Consequently, this implies that well-known products with a wide reputation of a good price-quality ratio should appear high on the list (‘branded products’).

These three factors might have a different effect on e-commerce depending on the kind of trade conducted. For instance, while distance selling is highly constrained by the efficiency and the costs of transport, e-commerce of digital services takes advantage of seamless transactions across geographical boundaries. Therefore, for digital content services, e-commerce is the tool of delivery scoring at the very top on all three characteristics (low weight, durability and brand selling). In essence, the bit signals sent via the Internet constitute the contents being purchased, and which are then being transformed into electronic books, music, films, games, TV-programmes, software tools for keeping track of a household's own economy etc.

While sales of on-line TV, music, games and movies were essentially non-existent a few years ago, they have been growing at a rapid pace in recent years and projections suggest that this will continue. Games and music were the two main digital items bought in 2011, with their on-line sales accounting for a 42 per cent and 32 per cent of total industry revenue respectively. They are also likely to account for a larger share of e-commerce sales while, at the same time, being a key driver of the rapid historic and expected growth of that sector as a whole.

The global digital and non-digital spending growth has shown a downward trend from 2006-2009, with the former showing a high percentage decline during this period, cf. Figure 2. However, after 2009 global digital spending has started to grow again and reached 12.9 per cent in 2010, compared to only a 2 per cent increase in non-digital spending, cf. Figure 2. In general, the global digital spending growth is higher than the non-digital counterpart throughout the period 2006-2015.
Finally, the most frequently on-line bought items were travel and holiday accommodations followed by clothes and sporting goods, which are purchased by 50 per cent of the buyers, cf. Figure 3. It is noteworthy that each of them belongs to one of the two kinds of electronic commerce we have defined above – clothes are a traditional distance-sold good, while travel tickets, which are purchased online through the internet, are purely electronically supplied services. Furthermore, downloading this latter type of goods, such as film and music and computer software, which do not usually require delivery because they are downloadable and/or printable, reduces the distance to nil, and therefore also the costs of cross-border transactions.

Therefore, empirical evidence broadly supports those three drivers as being important. Physical books traditionally reach the highest position on e-commerce surveys and are at the same time characterised as being (1) relatively expensive per kilo, (2) even a paperback lasts many years and escapes non-damaged from transportation.

**Figure 3: Online internet purchases by type, EU-27, 2010**

*Note:* The figures are expressed as per cent of individuals who both ordered over the internet in the past 12 months

1.3. **Stylised trends and prospects for e-commerce**

The Internet represents the most important platform through which electronic commerce is conducted. The consumption of goods and services by households over the internet, as well as the expenditure on accessing the Internet, represent the major impact of the Internet economy in the national GDP, cf. Figure 4. For instance, consumption over the Internet in the UK accounted for about 4 per cent of GDP, while internet-related investments and government spending together accounted for about 3 per cent of GDP.

**Figure 4:** The Internet economy as a percentage of GDP in 2009

![Percentage of GDP by country](image)

**Note:**
*Consumption: Goods and services bought by households over the internet and consumer spending on accessing the Internet
**Other Components: both private and public Internet-related capital investments and Net exports of online goods and services and Internet-related equipment

**Source:** Boston Consulting Group (2011), Turning Local: From Madrid to Moscow, the Internet is going native, September 2011

In monetary terms, the value of the turnover for the EU e-commerce (excluding micro enterprises) is estimated to be EUR 277bn. When only focusing on the retailing sector (B2C) the estimated turnover from e-commerce would be about EUR 184bn. Taking both together, B2B and B2C electronic transactions constitute 14 per cent of total business turnover in the EU. On the one hand, B2B represents the largest proportion of business e-commerce turnover and this share has been growing, cf. Figure 5. On the other hand, just about one fifth of business e-commerce turnover in the EU-27 is represented by B2C sales. This might be explained by the fact that businesses have been doing electronic transactions long before the electronic retailing boom – for instance, via EDI (Electronic Data Interchange) through VANs (Value-Added Networks).

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2 Boston Consulting Group (2011), Turning Local: From Madrid to Moscow, the Internet is going native, September 2011.
4 FTI (2011), Intra-Community Cross-Border Parcel Delivery, a study for the European Commission, December 2011, page 50. The study reports a value of £145.6bn which, at the monthly average exchange rate of EUR 1.18 in December 2010, corresponds to EUR 171.8bn.
Nevertheless, the importance of B2C e-commerce in relation to B2B might be changing. The percentage of individuals in the EU purchasing online has increased dramatically from 20 per cent in 2004, to almost 40 per cent of all individuals in 2010. In contrast, the percentage of firms involved in on-line purchasing and selling has been constant since 2004, cf. Figure 6.

**Figure 6: Percentage of individuals who purchased online in the last 12 months**

<table>
<thead>
<tr>
<th>Year</th>
<th>Enterprises purchasing on-line</th>
<th>Enterprises selling on-line</th>
<th>Consumers purchasing on-line</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>15</td>
<td>20</td>
<td>25</td>
</tr>
<tr>
<td>2005</td>
<td>20</td>
<td>25</td>
<td>30</td>
</tr>
<tr>
<td>2006</td>
<td>25</td>
<td>30</td>
<td>35</td>
</tr>
<tr>
<td>2007</td>
<td>30</td>
<td>35</td>
<td>40</td>
</tr>
<tr>
<td>2008</td>
<td>35</td>
<td>40</td>
<td>45</td>
</tr>
<tr>
<td>2009</td>
<td>40</td>
<td>45</td>
<td>50</td>
</tr>
<tr>
<td>2010</td>
<td>45</td>
<td>50</td>
<td>55</td>
</tr>
</tbody>
</table>

**Note:** Percentage of all enterprises, without financial sector (10 persons employed or more). Percentage of individuals who purchased online in the last 12 months

**Source:** Eurostat data base
When looking at cross-border e-commerce, there seems to be no reliable data available, as opposed to traditional cross-border distance selling. However, when making the very simplified assumption that the same proportion of e-commerce turnover goes cross-border as it does in traditional cross-border trade (17%), cross-border e-commerce turnover is estimated to be around EUR 47bn. According to FTI (2011), Intra-Community Cross-Border Parcel Delivery, a study for the European Commission, December 2011, Page 49. Accordingly, the share of enterprises conducting cross-border e-commerce and their turnovers is low, leaving a big potential for further gains. There is apparently a wide gap in the share of consumers engaging in cross-border e-commerce, ranging from well over 50 per cent in smaller countries while below 20 per cent in countries such as Germany and UK.

The internet economy is expected to grow further. For instance, in the UK the share of GDP related to internet based activities (mainly on-line consumption of goods and services) is expected to grow from 7.2 per cent in 2009 to almost 10 per cent in 2015, cf. Figure 7. Moreover, this tendency is even clearer in the case of the internet newcomers (i.e. Czech Republic, Italy, Poland and Spain) which are supposed to grow even faster until 2015.

**Figure 7: The Internet Economy as a percentage of GDP, 2009 and 2015**

In conclusion, e-commerce has to be seen as an international activity since consumers take advantage of opportunities outside their home market. Therefore, it is a very important factor pushing for more integration of the European single market. Prospects of the internet growth during the coming years together with the development of new electronic platforms will potentially promote businesses implying further upward tendencies in national as well as cross-border electronic commerce, with the latter being an important opportunity for European merchants.

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1.4. Consumers, e-commerce and VAT

The expected continued growth of e-commerce, in particular the digital part, increases the focus on how VAT systems affect the choice consumers make. Looking at the results of different surveys on electronic commerce and consumer behaviour, the most important driving forces to purchase online are price and time saving factors cf. Figure 8.

**Figure 8: The most important driving forces for purchasing online**

![Bar chart showing the most important driving forces for purchasing online. The price factor is the most important with 66%, followed by time saving factor with 50%, total time availability with 33%, specific products with 33%, convenient addressing with 22%, information factor with 19%, social information factor with 11%, delivery factor with 10%, and other with 16%.]

*Note:* “Total time availability” refers to the possibility of purchasing at any time. “Other” refers to better quality, physically shopping dislike, easier return policy.


**Price factor**

Consumers state that lower prices are the key driver of their online purchasing behaviour, followed by time savings and other broader choice factors. Nevertheless, each of these factors might have different effects on the final purchasing decision regarding physical goods as compared to digital content services.

Digital content services may generally be associated with lower transaction costs since there is no need for physical delivery. Given that the current VAT regimes in most of the Member States apply reduced rates on certain physical goods, whereas standard rates are applied to the online versions, consumers might be influenced to change their purchasing behaviour of seeking for the lowest price. Hence, the theoretical neutrality of the VAT would no longer apply.

**Time saving factor**

Consumers appreciate the possibility of enjoying the product right after the purchase is made. From this point of view, consumers might be expected to buy digital content services which are not subject to a physical delivery as an alternative to physical goods. When introducing the VAT consumers might face a trade-off. On the one hand, delivery costs are expected to reinforce their preference for digital content services over physical goods. On the other hand, given the higher VAT rates applied to digital content services purchasing decision might be distorted towards physical goods.
In relation to the rest of purchasing drivers, consumers would face similar trade-offs when the VAT impact is large enough, compared to other potential forces. Therefore, consumer preferences might be distorted by the current VAT system. Hence, future VAT regulation ought to take into account the potential behavioural consequences of different systems.

**Technology – progress and access**

The increase in e-commerce has been and will continue to be driven by progress in technology and innovation. A new area of application for e-commerce digital services is “cloud computing”. A popular definition is when customer “use services, or storage, not at your own computer somewhere else in the internet, which is not in one data centre but is spread all over the internet”. The growth of this market has basically been driven by the increasing speed and reduced costs with which data can be transferred over the internet. This has improved the economics of using shared external and professionally managed data bases as opposed to downloaded and often rarely used data. The EU market for cloud services has been estimated to grow from just over EUR 5 billion in 2009 to over EUR 20 billion by 2015.

In addition to new types of services, the total EU e-commerce market will also increase due to improved access to the internet and higher GDP per capita in the present lower-income countries. Indeed there is a very strong correlation between access to the internet and GDP per capita levels as well as between access to internet and on-line purchases. For the top four countries in terms of access to internet (DK, SWE, NL and LU) the share of consumers with on line purchases exceeded 85 per cent in 2010 while it was below 20 per cent in the three countries with the lowest access to the internet (BU, RO and GR).

**1.5. Summary**

In VAT terminology, e-commerce is typically defined along two dimensions, what is being sold and who is the customer? Sale of physical goods facilitated by internet is called distance selling and can to a large extent be seen as the partial replacement of pre-internet selling models based on telephone ordering and printed catalogues. By contrast, digital services are really a new type of product whereby a different kind of content such as e-books, games, banking services is provided directly over the net to the consumers, typically with no or only limited human action associated with the dispatch from the supplier side.

Products and services sold have certain common characteristics. For goods, they tend to have a high “price-to-kilo” ratio to allow for costs of transportation, they need to be non-perishable when transported over potentially longer distances and products/suppliers tend to have high brand recognition so that customers can safely buy a product at a distance where payment is typically provided in advance of the reception of the goods. For services, the first two characteristics do not apply as transport costs are minimal – basically costs of electricity – while digital services by definition can endure digital transport. This implies that media and entertainment products plus clothing tend to be the most important products and services in e-commerce.

E-commerce has become a large and increasing part of the EU-economy. Across EU Member States, e-commerce, broadly defined, accounted for 1 to 7 per cent of GDP in 2009 rising by some estimates to 2-10 per cent in 2015. On the top of the list are such countries as UK, Sweden and Denmark where the shares of GDP all exceed 6 per cent.

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9 European Parliament (2012b), page 15.
The main drivers of growth are three factors. First, consumers rate the lower costs as the main argument for purchasing in conjunction with the ability to compare prices when making the buying decision. Time saved is the second highest rated factor. A third, and more general driver is technology. Access to internet explains a very substantial part of the cross-country variation in the share of e-commerce in GDP. Furthermore, technology improvements are also key to what kind of digital content services will particularly grow. In recent years, cloud computing has been estimated to grow significantly, as the rapidly declining costs of transmitting data over the internet has increased the attraction of buying space for storing data and programmes at common external servers as opposed to using storage at own local computers.
2. SHORTCOMINGS OF THE PRESENT VAT SYSTEM IN DIGITAL SINGLE MARKET

In this chapter we provide an integrated presentation of both the theoretical and the practical shortcomings of the current VAT systems.

First, we will briefly present the rules of "supply" for VAT in relation to e-commerce in the EU i.e. country of origin (seller's country) or country of destination (buyer's country) (section 2.1).

Second, we provide a typology of generic distortions that may arise due to differences in VAT rates across countries, product variants and distributors/suppliers (section 2.2) and outline how that influences real-life behaviour, given the currently applied VAT rates within the EU (section 2.3).

Third, we deal with the complications that arise if you have one sale from one supplier consisting of multiple underlying products with different VAT rates and then with the reverse situation, where you have many intermediary suppliers joining to sell one product (supply chain issues in section 2.4). The VAT challenges that arise are partly, but not only, linked to differences in tax rates across products and suppliers.

Fourth, we describe the basic problems for suppliers in terms of identifying for VAT purposes to whom the product is sold, where and when a trade takes place, and at what price and what digital or electronically supplied services are (section 2.5).

Fifth, we describe the loss of tax revenues that result from the complicated EU VAT system that is applied to e-commerce (section 2.6).

Finally, we summarize the shortcomings of the present VAT system (section 2.7).

2.1. Basic set of VAT rules applied for e-commerce in the EU

The main legislative act governing the application of VAT rules for e-commerce goods and services in the EU is Council Directive 2006/112/EC of November 2006 on the common system of value added tax (further referred to as the "VAT Directive"). It is a comprehensive directive which brings various provisions together in a single piece of legislation. Yet, there have been amendments to this Directive over the years. Council Directive 2008/8/EC, amending Directive 2006/112/EC as regards the place of supply of services, is the most recent piece of legislation which defines, among other issues, the place of taxation for electronically supplied services, telecommunications and broadcasting services.

Currently applied and proposed VAT rules for e-commerce goods and services in the Member States can be summarised within the context of:

- Cross-border trade in physical goods versus trade in digital services;
- Business to Business (B2B) versus Business to Consumer (B2C) transactions for e-commerce services;
- EU versus non-EU based businesses delivering e-commerce services in the EU;
- EU and non-EU service consumers.

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The place of taxation for cross-border e-commerce goods transactions (distance selling) basically depends on the annual sales of the supplier, provided that the seller organises the transport service for the consumer cf. Table 2. Whenever a supplier’s annual sales value exceeds a threshold, which is applied in the customer’s Member State, the VAT rule of the customer’s Member State (or destination country) will be applied. However, the supplier may always opt on a country by country basis to apply the VAT rule of the customer Member State (destination country). Once opted, the choice will be valid for two consecutive calendar years in those Member States\textsuperscript{13}, cf. Table 2. The thresholds applied in the Member States vary (EUR 100,000 or EUR 35,000 or the equivalent in national currency), cf. Annex II, Table A3.

Table 2: Cross-border e-commerce goods transaction (Distance selling)

<table>
<thead>
<tr>
<th>Place of Taxation</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Country of destination</strong> for distance sales when the supplier’s annual sales are above the threshold* applied by the customer’s Member State and the supplier organises the shipping service for the consumers (Article 33 of 2006/112/EC VAT Directive)</td>
<td>A UK company is selling CDs via the internet to private customers throughout the EU and organising transport of goods for its clients. When CDs are sold to customers in Denmark, Danish VAT must be charged when the Danish threshold is exceeded while Dutch VAT must be charged to customers in the Netherlands when the Dutch threshold is exceeded.</td>
</tr>
</tbody>
</table>
| **Optional** for distance sales when the supplier’s annual sales are below the threshold* applied by the customer’s Member State (Article 34 of 2006/112/EC VAT Directive). Once the supplier chooses the place of taxation, the choice will be valid for two consecutive calendar years (Article 34 (4) of VAT Directive). | a. If the annual sales by the UK company (see above example) to a customer in Belgium do not exceed the Belgian threshold, the CDs will be taxed with the UK VAT rate. *(Origin principle)*  
b. When the UK company supplies to a customer in Luxembourg and the UK company has taken the option to tax at Luxembourg rate, the CDs will be taxed in Luxembourg rate *(Destination principle)* |

\textit{Note:} The country of destination always applies for products subject to harmonised excise duties (e.g. alcohol, wine, beer).* The threshold is EUR 100,000 or EUR 35,000 or the equivalent in national currency (see the DG TAXUD home page for country specific threshold http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/traders/vat_community/vat_in_ec_annexipdf)


In the case of e-commerce services consumed in the EU, the place of taxation depends on whether a transaction is B2B or B2C, whether the business providing the service is established in the EU or not, and whether a customer is resident in the EU or not.

With regard to B2B transactions relating to e-commerce services, if an EU based business delivers an e-commerce service to a taxable person established in the EU, the place of taxation will be where the recipient of the service is established, cf. Table 3. For example, a business established in Germany provides an e-commerce service to another business, a taxable person established in Belgium. The place of supply for such transaction is deemed to be in Belgium. The same rule will be applied if a non-EU established business provides a service to a taxable person established in the EU. If an EU established supplier renders a service to a customer established outside the EU, the place of supply will be deemed to be where the non EU customer is established. Following that and, depending on the rules in place in the country of the recipient, the recipient may or may not have to declare VAT on the purchase.

Table 3: B2B cross-border e-commerce service transaction (2010 and beyond)

<table>
<thead>
<tr>
<th>Supplier</th>
<th>Customer</th>
<th>Place of Taxation</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU-based businesses</td>
<td>Taxable business based in the EU</td>
<td>Customer’s Member State (1)</td>
<td>If a business established in Germany provides a service to a taxable person established in Belgium, the place of supply will be deemed to be Belgium. The customer will have to declare the VAT on the purchase under the reverse charge mechanism.</td>
</tr>
<tr>
<td>EU-based businesses</td>
<td>Taxable business based outside the EU</td>
<td>No VAT (1)</td>
<td>If the same German company provides a service to an American based company, the place of supply will be in the USA.</td>
</tr>
<tr>
<td>Non EU-based businesses</td>
<td>Taxable business based in the EU</td>
<td>Customer’s Member State (1)</td>
<td>If an Australian company provides a service to a customer established in France, taxation rules of France will be applied, and the customer will have to declare the VAT on the purchase under the reverse charge.</td>
</tr>
</tbody>
</table>

Note: Such a rule is also applied for telecommunications and broadcasting services. (1) is based on article 44 of the VAT Directive.


With respect to B2C transaction of e-commerce services, if an EU-established business delivers a service to a non-taxable person established in the EU, the place of taxation will be the Member State where the supplier is established (cf. Table 4). For example, when a business established in Germany provides a service to a private person (non-taxable person) resident in Belgium, the place of supply will be Germany.

However, the place of taxation for B2C transaction services will be changed to the Member State of the customer starting in January 2015. This change will force EU based businesses selling electronically supplied services, telecommunications and broadcasting services to other Member States to charge different VAT rates depending on where their customers reside. Moreover, after January 2015 the so-called “one-stop-shop scheme” will be available for EU based electronic e-commerce suppliers. “One-stop-shop scheme” is a simplification measure of compliance requirements, whereby suppliers of electronically supplied services to B2C customers resident in the EU may opt to account for VAT across the EU via a single registration and a single periodic electronic declaration. The scheme is
intended to simplify compliance requirements by avoiding the need for multiple-country VAT registrations which would otherwise be necessary.

At present, it only applies to non-EU based businesses. The scheme will no longer only be limited to electronic services but will also be available for telecommunications and broadcasting services.\textsuperscript{14}

The customer’s Member State taxation rule will be applied in case of a non-EU established business providing an e-commerce service to a non-taxable person living in the EU, cf. Table 4. For example, if an Australian company provides a service to an individual living in France, the taxation rule of France will be applied. No VAT will be charged for services provided to customers residing outside the EU.

\textbf{Table 4: B2C cross-border e-commerce service transaction (2010-beyond)*}

<table>
<thead>
<tr>
<th>Supplier</th>
<th>Consumer</th>
<th>Place of Taxation</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU-based businesses</td>
<td>Non-taxable person based in the EU</td>
<td>1. Supplier’s Member State regardless of where the customer is. (3) \textbf{(until 2015)}</td>
<td>If a business established in Germany provides a service, until January 2015, for a private individual living in Italy, taxation rule of \textbf{Germany} will be applied.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2. Customer’s Member State irrespective of where the supplier itself is established or VAT registered \textbf{(from January 2015)}</td>
<td>If the same German company, in the example above, provides the same service for a private individual living in Italy, from January 2015 onwards, taxation rule of \textbf{Italy} will be applied.</td>
</tr>
<tr>
<td>EU-based businesses</td>
<td>Non-taxable person based outside the EU</td>
<td>No VAT (art. 59 EU VAT Directive)</td>
<td>If any EU-based firms deliver a service to a private individual living in America, the place of supply will be the country of the recipient. Please note that there are some countries, such as Norway, Switzerland and Iceland where the EU based firm may have registration obligations if they supply services to end consumer resident there.</td>
</tr>
<tr>
<td>Non EU-based businesses</td>
<td>Non-taxable person based in the EU</td>
<td>Customer’s Member State (2)</td>
<td>If an Australian company provides services to an individual living in France, taxation rule of France will be applied.</td>
</tr>
</tbody>
</table>

\textbf{Note:} *Such rule is also applied for telecommunication and broadcasting. (3) is based on Article 45 of the Directive, (2) based on Article 58 of the Directive. The change for 2015 is based on Article 58 of the VAT Directive.


In summary, the place of supply rule for e-commerce services in the EU depends on whether the customer is a taxable or a non-taxable person and hence the taxable status (who) and the location (where) of the customer shall be determined by the supplier in one way or another. Moreover, digital services/electronically supplied services need to be defined in a precise way that allows them to be separated from a VAT perspective from other traditional services(what). We will discuss the present rules to answer these questions and their caveats if any, in section 2.5.

2.2. A basic typology of VAT rate related distortions

As we see it, the key content of the analysis is to review distortions to consumer choice that may result from the application of the present and future VAT systems.

The first dimension is the choice between digital and physical versions of essentially the same product, for example the choice between hard copy and e-book. This is what we will call the “Product Type Dimension”. This is represented by distortions along the vertical axis in Figure 9.

The second dimension is from which country the service is to be sourced: domestically or from abroad? This is what we call the “Internal Market Dimension”. This is represented by distortions along the horizontal axis in Figure 9 below.

This provides a very substantial number of possible types of distortions.

As we will document below, with the current legislation in place in practice distortions can go in all directions as indicated by the arrows inside the diagram. We will discuss the potential substantial improvements following the adopted change in the VAT directive to be finally implemented by 2015.

Figure 9: Possible distortions in e-commerce due to differential VAT treatment
The shortcomings of the present VAT system with respect to the Digital Single Market have received considerable attention in the recent years. In this context, our analysis will focus on two main sub aspects:

- Distortions of consumer choices as a result of:
- Unequal tax treatment of physical and digital variants of the same product;
- Location of e-commerce operators in different countries;
- Unequal tax treatment of distributors of e-commerce products;
- Barriers to creating the Single Market:
- The complexity and diversity of taxation rules increase (compliance) costs for traders and fiscal administrations; and hinder the development of a truly European scale e-commerce services and products.

2.3. Variation of VAT rates across countries, product variants and suppliers

2.3.1. Legal framework for setting the VAT rates

An important element to consider when evaluating the European VAT system is the various VAT rates implemented across countries, products, and suppliers. Such variation occurs due to the existence of more than one VAT rate (standard and reduced VAT rates) as well as the provision of exemption/non-taxable regimes to some selected suppliers.

The VAT Directive has allowed Member States to have different standard VAT rates. According to this directive, “Member States shall apply a standard rate of VAT, which shall be fixed by each Member State as a percentage of the taxable amount and which shall be the same for the supply of goods and for the supply of services”.15 It is also mentioned that such a standard rate shall not be less than 15 per cent.16 Currently, the standard VAT rates in Member States are in the range of 15 and 27 per cent.

The same directive also allows that “Member States may apply either one or two reduced rates” in Article 98(1) and in Article 99 the directive states that “The reduced rates shall be fixed as a percentage of the taxable amount, which may not be less than 5 per cent”. This rule creates an opportunity for Member States to apply different VAT rates across products.17 For example, a reduced rate is applied on the supply of physical books, newspaper and periodicals, as well as on the reception of radio and television broadcasting services. The same VAT directive also states that reduced rates shall not apply to electronically supplied services.18 However, Luxembourg and France have recently set a 3 and 7 per cent VAT rate on e-books respectively. The European Commission has launched an infringement procedure (case no 2012/4080) against France and Luxembourg as the VAT rates they are applying to digital books are assumed to be incompatible with EU law.19

There are also various VAT rates across suppliers in the EU. This is due to the fact that some suppliers (or suppliers’ specific transaction) are exempted. For instance, the VAT

Directive states that Member States shall exempt the supply of postal services in the context of universal services obligations. In addition, the same directive provides exemption for most financial services under Article 135(1) such as “transactions, including negotiation, concerning deposit and current accounts, payments, transfers, debts, cheques, and other negotiable instruments, but excluding debt collection” and others.

The existence of multiple VAT rates might affect the efficiency of the VAT system. It can also increase complexity, thereby increasing administrative and compliance costs. We will in turn discuss the implications of the existence of various VAT rates across countries, products and suppliers in the context of e-commerce.

### 2.3.2. Actual variation of VAT rates across Member States and product variants

There is a very substantial variation of VAT rates for the same product across EU Member States cf. Figure 10. For instance, Ireland applies no VAT on paper books compared to the 25 per cent rate applied by Denmark. As mentioned previously, France and Luxembourg apply reduced VAT rates on e-books, while the rest of the EU Member States use standard rates. With regard to standard rates there are substantial differences.

![Figure 10: Between-country differences in VAT rates for the same product variants](image)

Source: European Commission (2012b)

At the same time, there is unequal treatment of digital and physical versions of the same products within EU countries, with the main problem concerning higher relative taxation of e-books. In many EU Member States the supply of hardcopy newspapers, periodicals, books, brochures and similar items edited on printed material are subject to a reduced VAT rate such as in Germany where a 19 per cent VAT rate is applied to e-books compared to a 7 per cent VAT on paper books. On the other hand, digital newspapers, periodicals, books, brochures and other similar items published on other physical means of support (e.g. CD-ROM) or digital means (e.g. e-books) are subject to the standard VAT rate, cf. Figure 11. The difference in the VAT rates applicable to printed material on the one hand and digital publications on the other is a major concern for the publishing and newspaper companies due to the increased popularity of digital publications (“online” newspapers, articles, books).

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The direct distortions from the internal market relates to the fact that consumers have an incentive to get their purchases from a source with a low applicable VAT rate. Example: UK has a lower VAT rate on books than Sweden, so a consumer in Sweden will have an interest in buying a copy in UK and have it shipped to Sweden. Moreover, it may also favour the purchase of a digital copy from another country rather than a physical copy sourced domestically. This applies for example to consumers with high and uniform VAT rates in countries such as Denmark that can legally buy on-line products from countries with lower standard rates given the still valid rule of using the VAT rate from the country of supply.

In case of the e-commerce rules currently applied in the EU, as explained in section 2.1, there will be three main VAT concerns.

First, for a large number of digital e-commerce products – the rate applied is that of the country of the supplier as most of the consumers are non-taxable individuals. That provides an incentive to sell such services from countries with low rates such as Luxembourg. The changes in the VAT Directive to be implemented in 2015 will reduce such incentives in e-commerce service transaction in principle by going from the country of origin principle to the country of destination cf. Table 4 in section 2.1. However, this may prove no panacea for reducing the significance of tax induced choice of sourcing of digital services; these services imply both conceptual and practical enforcement challenges related to the application of the destination principles as discussed later.

Second, there is a tax optimisation scheme in distance selling through separating the sold product from the related shipping service. In case of distance selling of goods (e-commerce) above a certain threshold value of the destination country (the threshold varies from EUR 35,000 to EUR 100,000 or equivalent national currency) cf. annex II, Table A3, the place of destination VAT rule shall be used, provided that the supplier is the facilitator of the shipping service for the customer cf. Table 2 in section 2.1.

However, there is a scheme currently used by suppliers, who sell goods from an EU Member State with a low VAT rate to another EU Member State with higher VAT rate, so as to avoid charging a higher VAT rate. In such a scheme, a supplier refrains himself from organising the shipping service, in which case the rule of origin (low VAT rate) will be applied in the EU. For example, a Luxembourg shoe company is selling shoes via the internet to private customers throughout the EU. Customers are either able to pick up the shoes in Luxemburg or deal with a third party for the shipping of the shoes. When shoes are sold to customers for example in Denmark, Danish VAT (25 per cent) will not be
charged even if the Danish threshold is exceeded as the supplier is not the organiser of the transport service. In this instance, the supplier charges a Luxembourg VAT rate i.e. 15 per cent but not a Danish rate i.e. 25 per cent. This scheme may create competition distortion for those suppliers being in a similar position but organising the transport themselves. For example, assume another close competitor in Luxembourg, which does not apply this scheme because it allows the client to go directly to the national shop in its home country to return goods. And hence, if such a firm separates the transport service and the shipping service, there would be VAT complications as the rule of origin will be applied first and then with a return of goods in destination countries and rule of destination will be practiced. This scheme puts the latter firm, which applies the rule correctly, in a disadvantageous position.

Third, currently the threshold for applying the distance selling VAT rules varies in Member States, cf. annex II, Table A3 (EUR 100,000 or EUR 35,000 or equivalent national currency). Such variation might create distortion in such a way that the same product might be treated differently across Member States, which have different thresholds. For example, if the same product (value of EUR 40,000) is sold to two countries with different thresholds (one with EUR 100,000 and one with EUR 35,000) such product might be treated differently from a VAT perspective, and hence might distort consumers’ choice.

2.3.3. Actual variation of VAT treatment across suppliers

There is the problem of qualifying the service for VAT purposes and inequitable treatment of similar services which could distort competition between suppliers and limit consumers’ choice available in the market. We will note three examples below:

Payment facilitation: Originally the service provided by phone payment facilitator was tax exempt at least in the UK, because mobile phone payment services had been considered as financial services, which are VAT exempt services in the UK. However, phone payment facilitation is now assumed to be different from financial services such as credit card payments, and hence considered as a taxable business service. In essence, mobile phone payment services are a close substitute to credit card payment services. However, the former is liable to charge VAT while the latter is not. This will put phone payment facilitators in a disadvantageous position compared to their close competitors. Moreover, this might limit the consumers’ choice of payment systems if the phone payment facilitators fail to resist the competition and withdraw from the market.

Broadcasting: Some companies provide online service subscriptions through which a customer can directly access live TV programmes from home through the Internet. In Luxembourg, in the beginning, such a service was classified as an electronically supplied service and hence subject to standard VAT rate. However, a similar service delivered by close competitors is qualified as broadcasting services and hence subject to a reduced VAT rate e.g. 3 per cent. This puts the company, which delivers the online subscription, in a disadvantageous position. This problem is not unique to Luxembourg as it exists in other EU countries as well.

Postal services: All non-universal postal service providers in the EU are subject to VAT while universal postal service providers, irrespective of private or public ownership, will have VAT treatment which varies across activities and countries. An activity by universal service providers can be regarded as VAT exempt or non-taxable in one country while taxable in another. There are two main reasons why the VAT treatment of postal sector is different across Member States. First, there are different interpretations of how the VAT exemption is being applied to postal services on a national level. For example, a given

universal service might be VAT exempt in one Member State while it is not in others.\textsuperscript{23} Second, exemptions are applied to the specific Universal Service Obligations (USO), whose scope is different across countries (such as Austria, Belgium and others). The VAT treatment of universal service providers in the EU is illustrated in Annex I, Table A2. Such difference in treatment can create the following three potential distortions.

The first distortion comes into the picture when a domestically based online non-taxable buyer is compelled to choose between physical products from the domestic or foreign countries, due to variation in VAT treatment of postal market in a given Member State.

For example, most online sellers use bulk mail services to send their products to customers. Bulk mail delivery service is VAT exempt in Belgium in contrast to the Netherlands, where bulk mail delivery service is out of the scope of USO and hence liable to VAT.\textsuperscript{24} If a non-taxable person, based in the Netherlands, wants to buy an online bulk product such as CDs weighing 2kg (costs EUR 2.82 for delivery),\textsuperscript{25} and uses the Dutch Universal Service Provider (USP) for delivery, then the person will pay VAT to the USP in the Netherlands (an amount of around EUR 0.54 at 19 per cent VAT rate of total delivery cost). However, this is not the case in Belgium, where bulk mail service is exempt. Hence, a non-taxable person based in the Netherlands has an incentive to buy a product such as CDs online from Belgium and ship it to the Netherlands using Belgian and Dutch USPs to avoid VAT charges on the postal service. This distortion can also be present with other USO services such as magazines, whose delivery is exempt in countries like Germany but not in other countries such as Italy cf. Annex I, Table A2. As long as the VAT treatment of postal services is not harmonised across the EU, such distortion will exist.

The second distortion arises when an e-commerce buyer in a given country may be compelled to choose physical products (e.g. books) over electronically supplied services (e.g. e-books) when: first, there is no VAT charged on delivery service of the physical version, second the VAT levied on buying the electronic version online is higher than the delivering cost of the physical version.

One may argue that physically supplied goods are already favoured with zero or reduced rate compared to electronically supplied services (e.g. physical book versus e-book) such as in the UK. The argument here is that such initial distortion will be compounded by the VAT treatment of the postal sector if the VAT charged on the electronic version is higher than the shipment cost of the physical version.

For example, in the UK, bulk mail delivered by the USP is exempt while electronically supplied services are subject to standard VAT rate to the final consumer i.e. 20 per cent.\textsuperscript{26} Assuming the delivery cost is less than the VAT paid for the e-version of a product, the consumer will be tempted to buy the physical version over the electronic one of the same product. If a UK consumer buys a physical product (such as a movie on DVD) online and uses a UK USP for delivery, the consumer will get the DVD without any VAT added on delivery price. In this case, the consumer not only entertains zero VAT rate on the DVD price, but also pays no VAT to the UK postal operator.

The third distortion happens when an e-commerce buyer has to make a choice between two product type dimensions (physical versus electronic) in a given foreign country (cross-border trade), where there is differential VAT treatment for the physical product and electronic supplied services. For example, if a consumer from Ireland buys electronically

\textsuperscript{23} Example, TNT Post UK Ltd. Case No. C-357/07.
\textsuperscript{24} Schoorl, P. (2010), VAT in cross border postal market, CRNI conference presentation.
\textsuperscript{25} Based on price information of PostNL (2012), Postal Rates 2012, page 16.
\textsuperscript{26} Parrilli, D. M. (2008), European VAT and Electronically Supplied Services, Interdisciplinary Centre for Law and ICT (ICRI), Catholic University of Leuven, Sept. 2008.
supplied services from the UK (such as a movie), the consumer will pay the standard VAT rate to the UK supplier,\textsuperscript{27} i.e. 20 per cent.

If the same Irish consumer buys a physical bulk mail product (the same movie on DVD) online from UK and uses the two countries’ USPs for delivery, the consumer will not pay any VAT for the UK USP, as bulk mail is exempt in the UK.

In summary, once a consumer decides to buy a product, the VAT treatment of universal service operators in the EU, in circumstances mentioned above, favours physically supplied goods over similar electronically supplied services assuming the delivery cost is less than VAT paid for the e-version of the same product.

The inequitable treatment of the similar services and hence suppliers might even become more severe as of 2015, with a change of the place of taxation from the origin rule to the destination rule. Today, the difference on VAT rate applied on the same product with different versions (physical and digital) is a challenge for e-commerce consumers. Moreover, the same version might also be treated differently across countries. For example, an e-book will today be charged a 3 per cent VAT rate in Luxembourg while it will be charged with 20 per cent VAT rate in the UK. At present, a firm charges a 3 per cent VAT rate when selling an e-book across the EU from Luxembourg. However, as of 2015 the same firm selling an e-book in the EU will be forced to charge a different VAT rate depending on where the consumers are located.

Classification of similar services as taxable versus non-taxable or reduced versus standard rate have not been harmonised across the EU as we have seen in the above examples. Hence, it creates problems both for the suppliers and the consumers.

The bottom line is that the configuration of VAT rates across the EU, in conjunction with EU VAT rates across products and suppliers essentially can lead to distortions from physical to digital products, from digital to physical and generally favouring the supply from countries with lower VAT rates on either online or physical copies (the latter in particular if the destination rule is either not applicable or not enforceable in practice).

2.4. Supply chain issues

2.4.1. Mixed supply: one supplier, several products

A “mixed supply” occurs if a mixture of goods and/or services is valued together with a single all inclusive price. For example, for a single price a consumer may acquire the rights to both a hardcopy newsletter/magazine and access to an online softcopy version.

When the supply comprises different elements, the first thing to consider is whether or not the elements should be split out and treated differently for VAT purposes.

If the rules relating to the localisation of each of the items in the mixture arrive to the same conclusion and the elements are chargeable to VAT at the same rate, the value of the supply and the related VAT amount can be calculated in the usual way.\textsuperscript{28} However, if the rules relating to the localisation of the elements come to a different result regarding the place of supply, and the elements are subject to different VAT rates, it is of paramount importance to determine whether each element should be treated differently for VAT purposes, or one overriding principle will apply. In the latter case, the other elements would be treated as purely incidental to the underlying supply.

\textsuperscript{27} The VAT applied on electronically supplied services by EU based suppliers to EU resident non-taxable buyers is based on Article 56 and 63 of Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services, [OJ L 44, 20.2.2008]. For such kind of transaction, the place of taxation will be in the country of the supplier.

\textsuperscript{28} Milville, A. (2009).
Mixed supplies of e-commerce goods and/or services in the EU pose a challenge to comprehend the VAT due on delivered goods and services in three possible ways:

- Mixed or single supply?
- If single, which rate to which transaction is predominant, i.e. the principle service?
- If mixed, what is the relevant tax basis for the relevant VAT rates?

**Mixed or single supply:** First, from the outset it is very complicated to differentiate whether a given supply of goods or services is a single supply or a mixed supply.\(^{29}\) This will create a problem in calculating the VAT due on the total supply value. Two practical examples are given below, one from the UK and one from the Netherlands. The first example refers to the case law concerning Forexia (UK) Ltd, a UK based publisher supplying books and newsletters, both with a conventional method (hardcopy) and an online distribution (digital) at the same time for a given customer. In the UK, the former delivery (hardcopy) is zero-rated while the latter delivery (digital) is subject to standard VAT rate.\(^{30}\)

The main challenge was that whether the supply by Forexia (UK) Ltd had been a mixed supply (hard copy and digital) or a single supply (either of the two). The UK VAT Tribunal decided that the supply had been mixed and should be taxed with a different VAT rate, the conventional delivery being taxed at zero-rate while the online distribution should be taxed at the standard rate, cf. Box 1. In this particular example, the consumer was forced to pay the UK standard VAT rate (19 per cent)\(^{31}\) on the amount paid for accessing the digital content of the book. This action will incentivise consumers to stick to printed books (hard copy) instead of buying the ever-growing digital version of the book or a composition of the two. Moreover, firms may be reluctant to try to give customers a mixture of different goods and services with one total VAT inclusive price, as it is unclear how the final VAT treatment will be decided.

**Box 1: Case Law for physically and digitally supplied books in the UK**

Forexia Ltd, VAT and Duties Tribunal Decision No. 16041: The case where the traditional and digital supply of books and newsletters were to be charged on different VAT rates, the former being taxed at zero rate while the latter being taxed at standard rate. The main challenge was whether the supply by Forexia (UK) Ltd had been a mixed supply (hardcopy and digital) or a single supply (either of the two). The UK VAT Tribunal decided that the supply had been mixed and should be considered with different VAT rates, the conventional delivery being taxed at zero-rate while the online distribution being taxed at standard rate.

**Source:** Forexia Ltd, VAT and Duties Tribunal Decision No. 16041, Apr.22 1999(UK) cited in SMITH, Supra note 130, at 589

The second example refers to the case law analysing activities of a US-based software company delivering both the software's hard copy and a service to customise the software with the clients’ computer in the EU. Both were given to the Netherlands based business called Levob. The main challenge was whether such a supply was considered to be a mixed supply (hard copy and customisation service) or a single supply (either of the two).

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\(^{30}\) "The supply of text by electronic transmission (including e-books), via the internet, or similar means is standard-rated. Such supplies are of services, not of goods, and different VAT rules will apply to them (such as those on the place of supply of services". For more information refer to the UK tax authority HM Revenue & Customs web page.

\(^{31}\) Now the standard VAT rate in UK is 20 percent
The case was taken to European Court of Justice ("ECJ") and the Court found that the arrangement between the U.S. service provider and Levob involved a single supply of services, not a mixed supply of goods and services, since the economic purpose of the transaction was to supply functional software customised to the customer's requirements cf. Box 2.32

In this case, the ECJ gave a definition of a single transaction as “where two or more elements or acts supplied by a taxable person to a customer, being a typical consumer, are so closely linked that they form objectively, from an economic point of view, a whole transaction, which it would be artificial to split, all those elements or acts constitute a single supply for purposes of the application of VAT”. Levob was compelled to pay VAT on the supply of software customisation services.

Box 2: Case law for identifying a mixed versus single supply

Levob involves the VAT treatment of customized software supplied by a U.S. company to a business customer in the Netherlands. The customer was not able to recover VAT in full as it made VAT-exempt supplies of insurance services. Businesses that provide exempt services cannot normally recover VAT on costs related to their VAT-exempt activities, but they do not charge VAT on the services they provide. Under the agreement between Levob and the supplier, the software license was granted in the U.S. and the vendor handed over the carrier media containing the basic software there. Levob imported the carriers into the Netherlands. The U.S. vendor also agreed to adapt the basic software for the Dutch market. To do so, it installed the standard software and customizations on Levob's computer system in the Netherlands and trained its staff there. The license for the standard software program was granted to Levob for $713,000, of which $101,000 was payable on signing the contract and the remainder in 17 monthly payments of $36,000. The price for customization was agreed to be between $790,000 and $970,000, depending on the specification during the period of the agreement. Staff training cost $7,500 per person. The installation of the standard software and customization took place in 1997, 1998 and 1999, as did the staff training. Levob did not include the amounts paid for the standard software in its VAT returns (and therefore did not account for VAT on these amounts under the “reverse-charge” procedure). In January 2000, Levob asked the tax authorities for an assessment based on the amounts paid for the customization, installation and training performed in the Netherlands. However, the Netherlands tax inspector considered that the U.S. software provider had supplied a single service consisting of the use of the complete, adapted, software program, and assessed Levob for the total amount paid under the agreement.

Court’s judgement

The Court found that the arrangement between the U.S. service provider and Levob involved a single supply of services, not a mixed supply of goods and services, since the economic purpose of the transaction was to supply functional software customised to the customer’s requirements. The Court concluded that the predominant element of the single supply was the customization service, based on its importance to the purchaser, and on its “extent, duration and cost.” It also held that the service should be taxed under Article 9(2)(e) of the Sixth Directive, therefore VAT was due in the Netherlands under the reverse charge procedure.

Note: The case number is C-41/04 Levob Verzekeringen BV and OV Bank NVvStaatssecretaris van Financiën [2005] ECR I-09433

Source: Ernst and Young (2005); Levob- Important ECJ Judgment on VAT Treatment of Customized Software; International Tax Alert, page 1-2

If an apparent mixed supply is determined to be single supply, the single and appropriate VAT rate has to be selected. Studies show that the dominant part of the mixed supply will govern the VAT rule. However, it is not easy to determine which part of the mixed supply is to be considered as the dominate one. A practical case arose in the UK, when a food delivery company, Emphasis Ltd, allowed the customer to order food online and then delivered it to the customers’ location. If such food delivery had been classified as a “supply of catering services”, the standard VAT rate would have been applied. However, if it was considered as a “supply of food” the transaction would be zero-rated in the UK. It was decided that such a transaction should be classified as single supply, i.e. supply of food, and hence the transaction had been zero-rated. In this case, consumers will not be charged any VAT while at the same time they enjoy the online delivery services, which can obviously save time. However, if one considers the matter from the catering service supplier’s point of view, this particular case might distort competition as the catering service in conjunction with food delivery will not be charged any VAT while the catering service provided alone will be liable to charge a standard VAT rate.

If mixed supply is present, what are the relevant tax bases to apply? If a given mixture of goods/or services is set to be a mixed supply, which part of the taxable basis should be allocated to which part? For instance, if the above given example is set to be a mixed supply, which part of the taxable basis should be allocated to the supply of the catering service versus the supply of food? This will be a challenge to the supplier and hence to tax authorities in Member States.

In general, the present application of VAT rules across the Member States is not based upon a uniform and clearly understood framework for handling mixed supply. While the different cases from the Court of Justice of the European Union provide useful indications to the question raised related to mixed supply as shown in the above examples, the treatment of such supply in the Member States has not yet been harmonised and hence creates a problem for businesses engaging in intra-EU trade.

So far this has mainly related to national oriented compliance problems. But starting from 2015 when the origin rules changes into destination rules for B2C digital service transaction, sellers who are engaging in cross-border trade will of course have to know not only which rates to apply to specific products in 27 Member States, but also how the 27 different countries deal with mixed supply issues to get the VAT treatment right. This is a real problem considering the fact that Member States tend to practice various rules concerning mixed supply.

2.4.2. One product, several intermediary suppliers

Purchases of digital services by private persons are often made via third party platform providers (e.g. network sites, telecom service providers, agents and others) as compared to the content provider itself. To give a practical example, assume a person plays an online game, and needs to pay EUR 5 for further game services. He/she also decides to use a payment facilitator to pay through his/her mobile phone. At the end, the consumer’s mobile phone operator will charge the person EUR 5 to his/her phone bill (in this case the mobile phone operator, for example, will take EUR 1 for its service and the payment facilitator will take EUR 0,25 cents and finally the game provider (Merchant) will get EUR 3.75) cf. Figure 12. The varying ways of tax liability determination between the EU countries for such joint offering schemes lead to uncertain positions for the tax authorities, the providers and the customers as to the correct application and collection of VAT.

Figure 12: Phone Payment Facilitation process

Note: The red colour indicates a flow of services or goods between the merchants and consumers, the green colour indicates the monetary flow in the payment process

Source: Copenhagen Economics, own exposition

When many intermediate suppliers are involved, there is a high probability of double taxation as more than one supplier is involved in delivering the service, i.e. payment facilitators, merchants (such as the game provider) and mobile phone operators. If the suppliers are located in different EU countries or one of the suppliers is non-EU, there will also be a problem of determining the place of taxation. The first entity to possibly charge VAT in the above chain of intermediate suppliers are the merchants, as they invoice the service they are delivering to the final consumers. They will charge a local VAT in the EU when they deliver services to a non-taxable person until 2015. The second one is the mobile phone operators, which will charge VAT on the amount due for the game services along with its other services, which is called above the line billing. This creates a risk of double taxation unless the merchants, in close cooperation with the telecom operators, refrain from charging VAT on the amount paid for the game services, if it has already been charged by the telecom operator.

Some EU countries, for example Belgium, have a rule that can help to avoid this double taxation: they allow below the line billing, in which case the telecom operator will not charge any VAT on the services generated by the third party such as game providers. An example of that is provided in Box 3 below.

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35 This is the term used in telecom operating sector where the operators charge VAT on all billing price to their final consumer even if some of the services originated from a third party such as from game providers.

36 This is the term used in telecom operating sector where the operators only charge VAT on the services which originated from the operator itself, not on the services provided by the third party.
Box 3: Below the line billing: how does it work in practice?

To give a concrete example, assume that a consumer established in France plays an online game, for which the provider (merchant) is located in Luxembourg. While playing the game online, the consumer decides to play advanced level by paying the price of EUR 115. The consumer also decides to pay through his mobile phone, which is operated by a French telecom company. The payment is made through a mobile phone payment facilitator which has a business contract with both the merchants in Luxembourg and the mobile phone operator in France. Two VAT issues can be raised in this transaction. The first issue is which VAT rate shall be applied with the current rules, Luxembourg's or France's? The second issue is what if both suppliers charge local VAT on the service. In principle, if the Luxembourg merchant has already included the local VAT i.e. 15% in the EUR 115 price, the phone operator in France should not apply any VAT; otherwise, double taxation of the service will be imposed on the French consumer. If the same transaction occurs with a Belgium mobile phone operator such double taxation may not happen as the operator, based on administrative guidelines will apply the so called “below the line billing”-method. Therefore, he shall not charge Belgian VAT on the recharged service provided by the third party (in this case the third party is the game provider from Luxembourg).

Source: Copenhagen Economic based on stakeholder interviews

Another important issue that can create a double taxation situation in this domain is the situation where one of the service providers is a non-EU business. Thereby, the non-EU business provider is already forced to apply the rule of destination as of today. Assume we have a merchant of games supplying services from the US, a non-taxable customer in Germany and a payment facilitator in France. There will be two different rules that can be applied and possibly risk of double-taxation. From the US company's point of view, the service is provided from a non-EU country to an EU based non-taxable person residing in Germany. Hence the German VAT shall be applied. However, from the French telecom operator's point of view, the service is provided from an EU-based business to another EU non-taxable person living in Germany and hence based on the current rules, applicable until 2015, a French VAT shall be applied. A single consumer will, in this case, be paying VAT two times for the same service.

A final problem that can arise in the case of multiple suppliers delivering a single product (such as telecom operating business) is the liability issue as well as identifying the real provider of the product from a VAT point of view. For example, assuming that a telecom service provider placed in Luxembourg has an operator (agent) in Germany acting as an intermediary. In addition, assume that a telephone service is provided from a German telecom operator to a private consumer established in Germany. The service delivered to the final customer is a telephone service, and it is also clear that the service is provided to a private consumer residing in Germany. However the question is who provides the service – the Luxembourg telephone company or the German operator? Identification of the real provider is vital in this transaction for two purposes. First, the VAT rate to be charged on the service must be determined. The place of taxation for such kind of transaction (B2C service) until 2015 is based on place of origin (place of supplier) cf. section 2.1. In this particular example both the Luxembourg and German tax authorities may claim the tax due on the telephone service as it is not really clear who the actual supplier of the service is, at least for enforcing the VAT rule. Second, it is also important for identifying the one who is liable to collect the VAT due in this transaction – the Luxembourg telephone company (collecting the Luxembourg tax due) or the German operator (the German tax due)? To summarise, the current VAT rule applied does not give a sufficient explanation as to identification of the real provider of the service involving multiple intermediary suppliers. What element has to be considered to identify the real suppliers? Failing to clearly put such elements in place might create a problem for the correct application of the VAT rule.
2.5. Problems of identification: who, where and when at what price and what are digital services?

2.5.1. Who: how to identify the service buyer and applicable tax status?

As discussed in section 2.1, the place of supply rules for e-commerce service transaction in the EU depends on whether the customer is a taxable or a non-taxable person, and hence depends on the status (who) of the customer. This leads us to the first problem of identification: who is the customer?

The proof of taxable status (who) of a customer established in the EU is currently determined, among other criteria, by the VAT identification number provided by a taxable customer. According to Regulation no 282/2011 laying down implementing measures for Directive 2006/112EC\(^37\) adopted in 2011, unless he has contrasting information, a service supplier may regard a customer established within the Community as a taxable person:

- a) where the customer has communicated his individual VAT identification number to him and the supplier obtains confirmation of the validity of that identification number and the associated name and address;

- b) where the customer has not yet received an individual VAT identification number, but informs the supplier that he has applied for it and the supplier obtains any other proof which demonstrates that the customer is a taxable person or a non-taxable legal person required to be identified for VAT purposes and carries out a reasonable level of verification of the accuracy of the information provided by the customer, by normal commercial security measures such as those relating to identity and payment checks.

However, if the supplier demonstrates that the customer has not communicated his individual VAT identification number to him, he may regard a customer established within the Community as a non-taxable person.\(^38\)

As we understand from our stakeholder interviews, business clients are not always willing to cooperate and provide the necessary information about their status. Moreover, the administrative requirements regarding proof for status of business clients are not harmonised across Member States. Therefore, it is not always easy to identify the taxable status of clients (whether taxable or non-taxable) in a way acceptable to tax authorities in the EU and this creates a problem as to which jurisdiction has the right to tax, (origin principle versus destination principle), where to report and who is responsible to report the VAT due on the service.\(^39\)

For example, a digital service distributor, registered in Luxembourg, sells its service to another business based in Belgium. If the Belgian business is a taxable entity and has a VAT number in Belgium the transaction will be B2B in the EU. Hence according to the EU place of supply rule currently in force, namely the destination rule, Belgium VAT will be applied. If no VAT exemption applies to the supply, the Belgian recipient shall report the VAT due to the Belgian authority. However, if the Belgian business is non-taxable or exempt, thus has no VAT number, the transaction will be B2C and hence according to the EU place of supply rule, in this case place of origin, Luxembourg’s VAT rule will be applied and the distributor shall report the VAT levied to the authority in Luxembourg.

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\(^{39}\) It is the supplier in case of B2C transaction while it is a customer in case of B2B transaction.
In the absence of a clear and enforceable rule for identifying the tax status of the customer, the seller will suffer from cash flow problems as the VAT due on the business client will not be paid on time.

Currently, identifying the EU customer for B2C electronic service transaction may not be an issue as the origin principle applies in such transaction. Nevertheless, from 2015 onwards, identifying the location of the EU customer will be a vital issue as the place of origin principle will be changed to the destination principle for this kind of transaction. At the same time, methods that can easily be used for identifying customers of goods might not be good enough for tracing the customer of a service. For example, in the case of goods, it is more likely that they will be delivered to the customer’s address and hence the residence country of the customer can easily be identified. However, in the case of services, a customer may not always enjoy the service in the country of residence. This leads us to the second problem of identification: where does the non-taxable customer reside for VAT purposes?

2.5.2. Where: the location issue

The location (where) of the customer is currently identified by the information given to the supplier by a customer. As explained in Regulation no. 282/2011 laying down implementing measures for Directive 2006/112EC, such information can be the VAT identification number attributed by the Member State where the customer is established, the residence of the customer as specified by the information given to the supplier, the nature of the service provided and contract or order form.

In particular, in case of a service transaction between B2B, the destination country VAT rule will be applied and a supplier shall establish the place of supply based on information from the customer, such as a VAT identification number attributed by the Member State where the customer is established, and verify that information by normal commercial security measures such as those relating to identity or payment checks.

As of 2015, identifying the customer for B2C electronic services transaction will be an important issue; as the place of origin principle will be changed into the destination principle for this kind of transaction as explained above. This will especially be a big challenge for businesses delivering electronically supplied services to non-taxable person in the EU as it is not easy to trace the place of consumption for this kind of services.

Normally, the place where the recipient is located will be the place where the recipient has his residence. However, for services as opposed to goods, the address to which a digital service is sent – essentially an IP-address – could often be located in another country than the residence country of the customer as discussed below.

Currently, there is no clear and single criterion proposed for identifying the place of consumption for electronically supplied services. The European Commission is working on a proposal for implementing regulations to ensure the proper application of the rules post 2015.

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40 Currently the companies have to only identify the location of the customers to know the where about of the non-EU customers.
42 For example, digitalised music and films mostly delivered to non-taxable person.
45 Base interview with European Commission Staff for this study.
According to the interviewed stakeholders, available options such as an IP address and credit card information can easily be manipulated and/or provide conflicting information about residence. For example, in the case of an IP address, a person living in Belgium near the Luxembourg border can take his portable device, such as an iPad to Luxembourg and download five movies, in which case he will be identified with his IP address as a Luxembourg consumer. Thus, he will pay 15 per cent Luxembourg VAT rate instead of 21 per cent Belgium VAT rate. With respect to credit cards, an individual living in an EU country can have a US credit card in which case a person will not pay any VAT on the services as the person could be identified as a non-EU citizen. Identification of consumers’ location may even get more complicated if different Member States apply various methods, IP-address versus credit card.

The European Commission has not yet proposed which criteria could be taken into account, but it is likely that a set of criteria will have to be applied to determine the most correct place of consumption. We understand that it is likely that several criteria will be applied in combination – in other words, taking into account that the criteria may give rise to different results, and allowing for a “sense check” to come to the best conclusion.

2.5.3. When: the timing issue

VAT is generally due on the supply of goods or services affected for consideration within the territory of the country by a taxable person acting as such. In order to determine the timing for applying VAT to the transaction, the VAT Directive generally states that VAT shall become chargeable upon receipt of the payment and on the amounts received only.46

However, in case of pre-paid phone cards for instance, there is no clarity yet on the actual consumption of the credit available on the card, as various services (subject to different VAT rates) can be purchased via the pre-paid phone card. This also goes for other electronic vouchers or credits that can be exchanged in return for goods or services or that represent a price reduction. For this reason, a basic question arises about when and sometimes where transactions linked to vouchers/pre-paid payments should be taxed.

Practically, most of the interviewees (from the supplier side) offer an arrangement of pre-paid phone cards, pre-credit payment or other voucher systems to their clients and it is sometimes difficult to determine when to charge VAT. Is it charged when the vendor issues the voucher or when the customer redeems the voucher? Assume a simplified example that a person who receives a voucher from a Luxembourg shop attempts to redeem it from a similar shop in Germany. First, when shall the VAT be due? When the person receives the voucher from the shop in Luxembourg (at the time of issue) or when the person receives the product/service from the German shop (at the time of redemption)? Second, since this is a B2C transaction, which VAT rate shall be applied, the VAT rate of Luxembourg or Germany?

The practices in Member States are not coordinated. Some countries tax the most common types of vouchers on issue whilst others tax on redemption. This creates uncertainty for businesses, particularly those wishing to exploit single market opportunities. Where a voucher is issued in one Member State and used in another, the practical consequences of mismatches in taxation may happen i.e. either double taxation or non-taxation. For example, some Member States will treat a particular kind of voucher (say, a prepaid phone credit) as a payment on account to be taxed upfront whilst other Member States will deal with the same type of voucher by taxing at the time of eventual supply.

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If a voucher is issued in the former and redeemed in the latter, then both will levy VAT on the same supply. This is legitimate from both perspectives, but the result is double taxation. In the converse situation no Member State would levy VAT and the result is non-taxation.

The European Commission is well aware of such uncoordinated practices in Member States and published a draft directive to harmonise the VAT treatment to be applied to vouchers. This document makes a distinction between voucher versus other payment methods and single purpose voucher (SPV) versus multipurpose vouchers (MVP) and aims to simplify the VAT rules applied to vouchers in Member States.

2.5.4. What price: currency conversion rates for cross-border trade

There are various currency conversion rules across the Member States which create an obstacle for e-commerce companies selling cross-border to report the VAT due to countries where their consumers are located.

For example, a company, which has an e-commerce web-shop based in the Netherlands, processes the transaction only in two currencies i.e. in Euros and Pounds. This implies a hurdle with currency conversion while reporting the VAT due in countries, which have national currencies other than Euro and Pound.

To be more specific, assume a Danish consumer buys online EUR 100 worth of clothes from the company. The consumer has to pay in euro, but the company has to report the VAT in Danish kroner to the Danish authorities (due to the fact that the company is VAT registered in Denmark bound by the distance selling rules).

The Danish consumer is expected to pay a EUR 100 for the clothes and 25 per cent of VAT standard rate (assuming that the destination rule will be applied in this case). In this particular example, the above company will be obliged to report the VAT amount paid by the Danish consumer to the Danish Authority in Danish currency and hence has to apply a currency conversion rate. In order to convert the Danish currency to Euro the company needs to use an exchange rate from Euro to Danish kroner, but it is not possible to do that automatically at any market exchange rate. National authorities typically have a policy to harmonise conversion methods. In some countries, the authorities set periods within which the exchange rate applied shall be fixed. Others set that one has to do it by the monthly average exchange rate or use the rates of the European Central Bank (ECB) and so on.

Moreover, differences in currency conversion rules across the EU create a problem in recording the total sales amount (book-keeping) for distance selling company registered in Member States. For example, the above company records its distance sales in the Netherlands. If a customer from another Member State such as from Sweden makes a purchase, the VAT paid by the customer will be in Swedish kronor. However, the total sale for this customer has to be recorded in the Netherlands and hence in Euros. There is still a need to use an exchange rate to change the Swedish kronor into Euro. With the absence of harmonised currency conversion rule to apply, this will create a problem recording the total sales amount in a single currency, i.e. Euro in this case.

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2.5.5. What are digital (electronically supplied) services?

Understanding the meaning of digital or electronically supplied services is of paramount importance for VAT purposes, as there is a separate set of VAT rules applied for such type of service compared to goods and other services cf. section 2.1. For example, a physical newspaper is treated differently compared to its digitalised version, with the later version often being taxed with a higher VAT rate in Member States. So, what are digital services?

The 2006/112/EC VAT Directive does not provide an exclusive definition of what electronically supplied services are. It only gives an indicative list of such services in Annex II.

Such list comprises the following items:

a. Website supply, web-hosting, distance maintenance of programmes and equipment;
b. Supply of software and updating thereof;
c. Supply of images, text and information and making available of databases;
d. Supply of music, films and games, including gambling games, and of political, cultural, artistic, scientific, sporting and entertainment broadcast and events;
e. Supply of distance teaching.

However, Regulation 282/2011 provides the definition of electronically supplied services as “referred to in Directive 2006/112/EC shall include services which are delivered over the Internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, and impossible to ensure in the absence of information technology.”

Yet, the degree of human contact in delivering the service is not clearly stated as it might vary while delivering services. Traditional services such as those provided by a lawyer or an accountant helping a client are distinguished from electronically supplied services if they require more than a minimum of human involvement. The use of digital signatures and possibilities to automatize standard contracts could alter the degree of human involvement to such an extent that these services could fall into the scope of electronically supplied services.

In general, without clear and binding definition of digital services in the EU, Member States might treat the same product differently. Consequently, businesses will have a problem of complying with divergent VAT rules across the EU.

Again, this is a problem which has so far remained of a national character, due to the origin principle which “only” requires suppliers to understand and apply the rules where they are based (“origin principle”). Now they need to understand how the boundaries of digital services are interpreted and applied in 27 different Member States.

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2.6. Compliance costs

The VAT revenues in the EU accounted for around EUR 784 billion in 2009 or 21 per cent of national tax revenues.\(^{52}\) Yet, the complexities of the VAT rules, together with the divergent practices at national level and weak enforcement lead to substantial compliance costs, burdens and distortions.

Therefore, realising the full potential of VAT revenue in the EU is becoming difficult. For example, the difference between actual VAT revenues and what they would have been with full compliance in the EU is significant, estimated as an average of 12 per cent of liabilities in 2006 the so-called “VAT gap”.\(^{53}\)

The main cost burden for businesses brought about by the VAT system in the EU is due to the differences across Member States in VAT-related administrative procedure, placing particularly considerable complexity for those wishing to trade across borders.\(^{54}\)

The cost for taxpayers to comply with VAT obligations (further referred to as “compliance costs”) has been extensively studied.\(^{55}\) Although there is no convincing study to our knowledge which captures compliance costs for e-commerce specifically, it is possible to approximate the compliance costs borne by European businesses. A major part of the businesses compliance costs is brought about by the so-called “administrative costs” which are defined as the costs incurred by businesses in meeting legal obligations (Information obligations)\(^{56}\) to provide information on their action or production.\(^{57}\)

The European VAT system imposes administrative costs of around EUR 80 billion\(^{58}\) on businesses. Of course, part of these administrative costs is inevitable – being necessary for simple “business as usual” operation – but due to the complexities and lack of harmonization across the EU, 87 per cent of those costs might be avoidable (EUR 69 billion).\(^{59}\) This is the so-called “administrative burden” which is defined as those costs related to information that is solely collected because of the legal obligation.

Among compliance issues often raised by interviewees are the administrative hurdles related to VAT registration in the Member States. Such a problem is encountered by every non-local e-commerce distance seller in a way that it takes a longer period to get VAT registration in some EU countries such as Bulgaria, Estonia or Lithuania.\(^{60}\) Moreover, the administration burden for obtaining the VAT number in the EU is also mentioned to be cumbersome and time consuming, and hence some interviewees even put forward a

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\(^{53}\) Reckon LLP (2009): Study to Quantify and Analyse the VAT Gap in the EU-25 Member States, A report for DG Taxation and Customs Union, European Commission.


\(^{55}\) Ibid.

\(^{56}\) In order to measure the administrative burden, literature makes use of Information Obligations (IOs), Stated Possibilities and Non-Stated Possibilities. The former refers to requirements to provide information imposed on business by the Directives and Regulations. Stated Possibilities are created when the European legislation gives Member States discretion to introduce additional requirements beyond the IOs. Finally, Non-Stated possibilities concerns additional information Member States requires even though it is not stated in the EU legal texts.


\(^{60}\) From interviewing companies operating distance sale in the EU.
suggestion that an online VAT registration portal for the EU can easily be set up. Thereby, it would be possible that any company which needs to obtain a VAT number across the Member States can easily obtain it through applying to the single web portal. The VAT number for businesses is often used as a proof that their business has a taxable status and hence qualifies for refund. The administrative cost for obtaining such information is estimated to be around EUR 94 million for EU businesses.\footnote{Capgemini, Deloitte and Rambøll (2009), EU Project on Baseline Measurement and Reduction of Administrative Costs – Final Report - Measurement data and analysis as specified in the specific contract 5&6 on Modules 3&4 under the Framework contract No. ENTR/06/061 Report of the Tax Law (VAT) Priority Area (March 5, 2009) at 126-130.}

Another compliance issue is the huge cost burden that will be generated on e-commerce businesses when place of taxation changes from place of supplier to place of customer in case of B2C service transaction after 2015. Currently, a digital service supplier established in Luxembourg, in principle charges 15 per cent VAT on its electronic services. However, with a change to place of destination rule after 2015 i.e. where the consumers are living in the EU, there will be huge costs generated for identifying the customer plus complying divergent administrative requirements in the Member States – which and how long the information shall be stored by the business to identify the place of residence of the customer. A one-stop shop scheme that will be operationalized for EU-based businesses as of 2015 might reduce the cost burden associated with VAT registration costs across Member States.

As of 2015, price information might also have to be changed based on the destination country’s VAT rate.\footnote{We would suggest that this is not an obligation – but may nonetheless be the choice taken by the suppliers.} A simple example can illustrate this problem. Assume that a Danish or Belgian online consumer can currently buy software priced at EUR 100 plus 19% of VAT from a digital service supplier based in Germany. However, with a change of place of the supply rule after 2015, the Danish consumer would have to pay EUR 125 (including a 25 per cent Danish VAT rate). In comparison, a Belgian consumer would pay EUR 121 (including a 21 per cent Belgium VAT rate) for the same software service provided by the same digital service supplier. Hence, the same service will be charged with two different prices just because the consumers are located in different countries. Some interviewees point out that such changes are likely to create compliance costs for businesses.

Finally, rules related to invoicing and auditing in the Member State are not yet harmonised and hence create compliance costs for businesses. Member States impose different information obligations concerning invoicing. For example, some interviewees stated that some countries require detailed sales reports for individual transactions, while others do not. The cost associated with complying with VAT audit rules and regulations for EU businesses is estimated to be around EUR 90 million.\footnote{Capgemini, Deloitte and Rambøll (2009), EU Project on Baseline Measurement and Reduction of Administrative Costs – Final Report - Measurement data and analysis as specified in the specific contract 5&6 on Modules 3&4 under the Framework contract No. ENTR/06/061 Report of the Tax Law (VAT) Priority Area (March 5, 2009) at 126-130.}
2.7. **Summary of shortcomings**

The EU VAT system for the treatment of e-commerce has increasingly moved in the direction of a destination based system in the sense that the ultimate VAT rate on purchases by consumers – B2C – is the rate applicable in the residence country of the consumer. For distant sales above certain thresholds, this has already been the case for a number of years; for digital services it is to become a reality in 2015.

The move towards destination based rules of supply is particularly helpful in reducing distortions in consumer choice for digital content services. Costs of transportation and more generally the costs of long distances between purchaser and vendor are limited if not zero: it does not cost more for a Swedish consumer to download a film from Spain or Cyprus compared to from a domestic vendor of digital services.

Yet, there are substantial outstanding issues related to VAT treatment of e-commerce that have not been considered. Some of these are long standing and related to essentially different VAT rates applied across countries, between product variants and intermediaries in the e-commerce supply chain. We have noted the classical mixed supply problems as well as distortions arising from VAT treatment of financial and postal services.

Others are essentially the consequence of the decision to use destination-based rules to define the country of supply for digital content services. Vendors will have to answer the “who”, “where”, “when” and “what” questions to identify the appropriate VAT rules to apply, which implies a good operational knowledge about VAT rules across all EU countries. Furthermore, purchases of digital services may end up being subjected to double taxation due to different interpretations of the character of the supply between different Member States.

The EU has most recently adopted implementing guidelines on how to apply the destination rules in practice. But as described above, they do not offer sufficiently precise guidance to traders about the appropriate VAT treatment.

While VAT provides substantial revenues – over 20 per cent of total tax revenues in 2009 – it is also very costly to operate while suffering from non-compliance. Total compliance cost has been estimated at EUR 80 billion of which EUR 67 billion may relate to its complexity and variation across EU. At the same time, an estimated 12 per cent of VAT due is not being paid. While these deficiencies are not in any way narrowly linked to the VAT treatment of e-commerce, the very fact that e-commerce is by its nature so linked to sales across-borders and is so digitalised in its operations, suggest that VAT compliance reform could naturally focus on e-commerce as a test case for more far ranging reforms.

Hence, in chapter 3 we review what options have been put on the table to deal with policies determining the scope for the variations in VAT rates and the treatment that fundamentally drives the distortions as well as more practical, yet highly important, steps that can be taken to help vendors and trade to apply the right VAT treatment and improve VAT collection while reducing compliance costs for traders.
3. EVALUATION OF OPTIONS

The December 2011 communication from the European Commission recognises that the dispersion of VAT rates across countries and products, as well as diverse administrative practices, is a problem both in terms of the distortions that are created for consumer choice as well as the compliance burdens it creates for business and tax authorities.\(^{64}\) Acknowledging that there is solid resistance among stakeholders to a move towards a fully origin-based VAT system – the strongly preferred option of the Commission ever since the adoption of the EUs VAT system – it calls for a more fundamental review of what it takes to run a permanent VAT system based on the destination principle. In particular, one of the main challenges to deal with in this context is the rapid expansion of e-commerce digital services.

Over the course of the last 3-4 years, the European Commission has presented several proposals ranging from Communications outlining the broader direction in which to deal with VAT policy to specific directives that determine how such principles should be put into practice. These proposals address a large number of shortcomings and challenges that the current VAT system faces in dealing with e-commerce, for instance in the context of moving to a destination principle from 2015 for B2C digital services transaction.

In this chapter, we assess area by area the degree to which these proposals,\(^{65}\) if adopted, would solve identified problems. In addition we point out which obstacles they face in getting adopted and what further options could be proposed to advance the proper functioning of e-commerce from a VAT treatment perspective. First, we discuss the overall perspective of getting an EU tax system with more uniform and simplified VAT rates as outlined in recent communications (section 3.1). Second, we discuss the proposals intended to address a number of more practical but equally important elements in making the VAT system function in practice (section 3.2, 3.4, 3.5). Section 3.6 contains a summary.

3.1. Uniform single rate preferred but realistic alternative to be considered

In the December 2011 communication the European Commission stated that it would launch "an assessment of the current VAT rate structures", and present respective proposals in 2013 after having consulted stakeholders.

The Commission has outlined three priorities for this assessment:

- Abolition of the use of reduced rates when they are an obstacle to the functioning of the internal market;
- Abolition of the use of reduced rates for which the consumption is discouraged by other EU policies (for example health or environmental policies);
- Ensuring equal VAT treatment for similar goods and services, explicitly taking into account any progress in technology.

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\(^{65}\) The relevant Communications adopted and proposed directives and commissioned studies are referred to in the literature list under the heading of European Commission.
With regard to the first priority, e-commerce in the context of B2C is arguably the most sensitive of all consumer markets in the EU with respect to price differences between countries and products. As such, reduced rates in some countries, for example books – or even more so e-books – are likely to shift sourcing of products to other countries at least from the private consumers’ perspective. This is linked to the fact that the enforcement of the destination principle to digital services from 2015 will not be without obstacles. The lower the dispersion in rates, the less incentive to shop across-borders due to tax-induced differences and the less need for control of costly procedures and auditing to ensure enforcement.

With regard to the second priority, reduced rates for physical products as opposed to digital variants may in fact tremendously decrease the possibility of following certain objectives at EU and Member State level. The present directive allows reduced rates for physical media outlets but not digital, thus favouring paper based production as opposed to delivering the same content to consumers by way of the internet. This puts unnecessary pressure on the environment by favouring a distribution channel with adverse environmental effects that could be avoided. Introduction of the physical version requires use of paper that is highly energy intensive in production. In addition, the delivery of copies to final consumers requires the transport from printers to either the residences of the consumers or the often small or highly spread outlets, both often located in, or close to, highly urbanised areas. This further requires energy intensive transport services while possible also adding to other environmental problems such as noise, air pollution etc. By contrast, the energy use associated with sending digital content is far lower while local environmental pressures from power generation is much lower than from retail distribution of physical copies. Most generators are placed far from city centres while local air pollution can be contained far easier and at lower costs. Thus, the current VAT policy stands in the way of a major substitution towards more environmentally sustainable product variants.

Furthermore, seen from a wider cultural and educational perspective, one could argue that allowing reduced rates on digital content "cultural services" such as e-books as well as for physical books would in fact help deliver the desired objectives at lower costs. This is one of the basic objectives that provided the rational for the reduced rate for physical books in the first place, namely to promote and make economically accessible goods and service for a wider part of the population.

With regard to the third priority, it could mean dropping reduced VAT rates on physical books. This might be a politically challenging manoeuvre and could perhaps best be undertaken in the context of broader VAT rate reforms. We will provide an example to support this argument based on the current rate structures in 9 EU countries accounting for the vast bulk of GDP in the EU: if reduced rates on books were to be raised to current standard rates in these countries, then 4 countries would have to raise rates on physical book by an excess of 15 percentage points, while 3 countries would have to raise it by 10 to 15 percentage points cf. table 4. However, if all reduced rates were eliminated then the required increase would be much lower for these countries because the increase in revenues from the abolition of reduced rates could be used to reduce the standard rate.
Table 5: Effect on VAT rates with standard rating of physical variants of e-commerce

<table>
<thead>
<tr>
<th>Rate increases, intervals in percentage points</th>
<th>Increase in VAT rate on books with no VAT reform</th>
<th>Increase in VAT rate on books with one uniform VAT rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>(&lt; 0]</td>
<td>BE, PL</td>
<td>-</td>
</tr>
<tr>
<td>(0 - 5]</td>
<td>-</td>
<td>DE, EL, HU</td>
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<tr>
<td>(5 - 10]</td>
<td>-</td>
<td>BE, ES, FR, IT, PL, UK</td>
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<tr>
<td>(10 - 15]</td>
<td>DE, ES, FR</td>
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<tr>
<td>(&gt; 15]</td>
<td>EL, IT, HU, UK</td>
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More generally, VAT incentives are rarely well targeted tools for encouraging the use of socially desirable goods and services. In contrast, they increase the complexity of the system, increase compliance costs and distort households’ spending patterns, reducing welfare.66

The difficulties in using VAT incentives in the areas of culture and media are increasingly compounded by new technology platforms and change of business models in the industry. These points go beyond the discussion of physical books versus e-books.

A relevant example is the VAT rating of broadcasting services which, as mentioned in Chapter 2, can benefit from reduced rates and may in fact lead to distortions of competition. The argument is the following. The criteria for being treated as a broadcaster are that broadcasting services are shown in real time i.e. not on demand. However, an increasing number of traditional broadcasting services allow their consumers to view radio and TV shows, news and entertainment in general at the discretion of the customer (on-demand services). Consequently, this is a service that is very difficult to distinguish from the service provided by media companies at full VAT rating.

A possible, but not very workable, solution would be to force broadcasting services to charge VAT on their on-demand services. However, this a near hopeless task as the relevant tax bases for the tax-exemption and the fully rated part respectively would be very difficult to establish: The customer will typically buy a mixed supply service – access to both real time and on demand products – while the company would be producing essentially just one product which can either be seen at a predetermined time, as announced in the programme, or when the consumer chooses to. Splitting costs on these two parts will be nearly impossible.

A second solution would be to drop the low rating altogether and provide a specific subsidy to the activity that the exemption was meant to support in the first place, independent of the particular technical format chosen by the producer/consumer – for instance, high quality news coverage.

Setting Priorities

The communication by the Commission, as well as the relatively weak progress on a number of VAT rate related proposals, suggests that the move towards more uniform rates will be a long-term project.

In our view, the priority for VAT rate related reforms should hence focus on agreements in areas where the distortion related to differences in VAT rates are most blatant as well as areas leading to the largest compliance burdens for businesses. In the context of the focus for this study, this could lead to overall three priorities:

- **First, equal rating of both physical and digital variants of a number of e-commerce products.** That calls for either standard or equal rating of both. We discuss this choice in section 3.2 below in a broader and global perspective;

- **Second, a broader review of the use of reduced rates/exemptions to promote educational and cultural objectives.** Such a review would have to go further than a pure VAT policy discussion and include whether other budgetary instruments could better serve the desired goals while also removing the type of distortions alluded to above in the discussion of VAT treatment of broadcasting services. In the same context, we would recommend that the VAT treatment which applies to broadcasting (in particular public service broadcasting institutions) is examined. Such public institutions are increasingly operating with business models and services that are getting closer to private market models;67

- **Third, more uniform and market neutral VAT treatment of the financial and postal sector.** For the financial sector, equal types of digital payment facilities should receive equal VAT treatment, irrespective of the status of the supplier (bank or non-bank). The proposed VAT directive on financial services goes in this direction68, but progress has been blocked in negotiations with Member States. Pending a change in the directive, we propose that the European Commission working with Member States use the established jurisprudence for the Court of Justice of the European Union as a guide towards a more uniform practice across Member States. For the postal sector, the outstanding challenges have been increased rather than lessened with the 2010 "clarification" of the VAT treatment of cross-border postal market as indicated in the Box 4 below.

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68 The proposed amendment to the directive on financial services put forward 3 main proposals to deal with the problems created by present VAT exemptions to certain financial and insurance services. As recognised in the Commission’s documents, there is both a widespread recognition that the present definitions of exempt insurance and financial services is out of date as well as an understanding that “a root and branch overhaul “ of the VAT system is not politically feasible. Hence, a more practical approach has been chosen focusing on three principles: (1) Clarification of the rules governing the exemption form VAT for insurance and financial services. (2) broadening of the scope of the present option of opting out of the exemption and (3) introduction of cost sharing groups which allows economic operators to pool investments and re-distribute the costs for these investments. It is the first proposal that is directly relevant to e-commerce. Inter alia, it clarifies that tax exemptions, when allowed for by the directive due to the nature of the activity, should be provided to all economic agents undertaking them not just for instance, banks. This follows also from the well-established jurisprudence of the Court of Justice of the European Union. This should help address the problem we identified in section 2.2.3 under the heading of “Payment facilitation”. Indeed, the problem, as seen by the Commission, is that the well-established jurisprudence, which in principle has direct application in Member States and should lead to a more uniform and not distorting practice, is far from universally applied. This would make a more top-down codification of what is exactly meant by exempt services a helpful exercise, which the directive proposes under the heading of clarification.
Box 4: Clarification of the Council Directive on cross-border postal market


Before 1 January 2010, cross-border mail has been effectively exempted from VAT in the EU. This was because according to the old rules, the place of supply for cross-border mail was in the destination country. Thus, the terminal due that the sending operator from country A paid the delivering operator in country B was considered to be taxable according to the rules in country B. Member States interpreted cross-border mail to be eligible for the VAT exemption as part of “public postal services” on the basis of by article 132 (1)(a) of Directive 2006/112/EC. Therefore, inbound cross-border mail was always considered as exempt from VAT. In fact, Schoorl (2010) notes that “…none of the universal service providers has ever paid VAT on terminal dues. This includes Member States that do apply VAT to domestic services like Sweden.”

Directive 2008/8/EC has changed rules regarding the place of supply since 1 January 2010. In the context of cross-border mail, the place of supply is no longer the destination country but the sending country. Moreover, the new VAT rule must be interpreted jointly with the Court of Justice ruling in the case TNT Post UK (Case C-357/07). This means that three conditions must be fulfilled simultaneously for cross-border mail to continue to be exempt from VAT:

- The specific postal service to be provided cross-border must be part of the universal service in the sending country
- The sending operator must be acting in capacity as a universal service provider
- The delivering operator must be acting in capacity as a universal service provider

In practice, this leads to unequal treatment since the scope of the universal service is not harmonised across Member States.

Before the 1st January 2010 cross-border mail has been effectively exempted from VAT in the EU. This was because according to the old rules, the places of supply for cross-border mail was in the destination country and inbound cross-border mail was always considered as exempted for VAT purposes. However, since 1 January 2010 cross-border mail, the place of supply is no longer the destination country but the sending country. Moreover, other considerations have to be taken into account to treat cross-border mail as part of universal services and hence exempt activity. We believe this in practice leads to unequal treatment of cross-border mails across Member States as the scope of the universal service is not harmonised across Member States. As long as the VAT treatment of the cross-border postal market is not harmonised across the EU, the distortion that may arise in the e-commerce market due to unequal treatment of the postal sector, as elaborated in section 2.3.3, will persist.

Source: Based on Schoorl, P. (2010), VAT in cross-border postal market, CRNI conference presentation
3.2. A challenge: imposing destination rules globally for digital content services

As a final note on VAT rate setting, we suggest that there will be substantial challenges associated with the standard rating of e-commerce products in a world where consumers can shop globally, not just within the EU, for digital products. Three points are worth highlighting.

The first is that co-operation with fiscal authorities on defining the basic rules of cross-border VAT treatment of e-commerce products at a more global scale is still at the early stages. The OECD has led the way with a number of suggestions for how to deal with it in a number of practical ways. Some of these suggestions will be discussed in some of sections below on the practical implementation of VAT in cross-border situations. The communication by the Commission explicitly refers to the role that the OECD plays in this respect and calls for the EU VAT Committee to play a role in helping the EU to form common positions in OECD context. It also notes that fiscal co-operation between EU Member States and countries outside the EU are far weaker than internally. This is a challenge as the destination rule for digital service imports to the EU requires jurisdictions globally to enforce EU rules in their own jurisdictions, most often to the disadvantage of these jurisdictions. Cloud computing services has been identified as an area where the location of servers could be located “geographically anywhere in the world”.

The second point is that the destination principle implies that non-EU businesses will have to operate with a business model that allows correct VAT treatment for cross-border sales for 27 different Member States. As clarified in table 3 in section 2.1, non-EU businesses selling to non-taxable persons already have this obligation for both e-commerce goods and services. However, the extent to which this rule is being enforced is unclear and the data by which to evaluate enforcement does not really exist. The basic fact remains that any digital service supplier at a global scale selling even the lowest value good to an EU customer needs to apply the rules applied in the different Member States. As digital content services are to be taxed at standard rates – and are so today with a few exceptions – they “only” need a system that is capable of identifying 27 different VAT rates. However, they also need audit systems etc., which ensure that revenues are then transferred from a country of registration to the relevant EU country to which the product is sold. We suggest that achieving this might be an uphill struggle. Baring in mind the high level of mobility in the choice of location of such services, it is not clear that EU co-operation to ensure compliance with key trading partners in the developed world – example OECD countries – will suffice.

The third point is that some of the key partners do not in fact impose destination rules for e-commerce cross-border transactions, let alone digital services within their own countries. This applies for example to the US. For the destination state within the US to acquire the right to the sales taxes associated with a sale from an out-of-state vendor to a customer in the destination state, a so-called sufficient "nexus" between the vendor and the destination state has to be established. That may take the form of some physical presences (sales office) or sales/promotion agreements with resident firms.

Indeed, the ability of the states to claim sales tax revenues from such sales are constrained by rulings from the US Court of Justice, interpreting narrowly the interstate commerce

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clause in the US Constitution.\textsuperscript{72} Our point is not to pinpoint different principles regarding where sales tax/VAT revenues are due in the US and EU respectively. Rather, it is to pinpoint that the tax administration within the US are supposed to set-up, monitor and enforce a destination principle for consignments to EU customers that at present do not apply to sales across state borders within the US. Moreover, many US states do not at present apply any VAT or sales tax to digital content services at all while often applying sales taxes to physical books.\textsuperscript{73}

As acknowledged by the European Commission in its Communication from December 2011, effective and operational co-operation with tax authorities outside the EU is much less developed than within the EU.\textsuperscript{74} Enforcing the destination principles on global digital e-commerce supplies to EU customers will be a challenge. The analysis above underlines this point.

Hence, we would propose an alternative scenario where EU allows reduced, preferably uniform, VAT rates on the group of products and services constituting the bulk of e-commerce. The arguments in favour are clarified above. We find that it contributes to all three priorities with a very small caveat. In contrast to standard rating of both physical and digital variations, both are now taxed at reduced rates. In principle this introduces a new distortion namely that digital, along with physical variants of e-commerce are taxed at lower rates than all other goods and services. However, we would argue that consumer choice and economic welfare is more adversely affected by differential VAT treatment of near substitutes, such as electronic and physical books, than goods and services that are weak substitutes, such as e-books and other general consumption. This policy would produce the opposite result as the previous scenario, namely reduced rates for the country that is currently standard rating all e-commerce goods and services. This option would in particular be attractive for Member States with high standard rates and few options to reduction by way of broad based VAT reforms as they already apply standard rates across the board.

We think that it is worthwhile to explore this option further reviewing more clearly the pros, as outlined above, and cons that need to be spelt out as well. Questions that should be addressed to provide an overall balanced answer are inter alia:

- Will VAT revenues from digital services taxed at lower rate be as large as with a standard rate imposed on a smaller tax base due to increased market shares from non-EU suppliers by lack of effective enforcement of the destination principle?
- Are we creating new problems? One example might be the risk that reduced rates on digital services undermines the tax base for standard rated goods and services. This can happen through "mixed" supply mechanisms where prices are manipulated so that the digital service component dominates the total supply, making the entire service non-taxable;
- Should the focus be only on reduced rates for digital content services particular prone to "leakage" to non-EU Member States?

\textsuperscript{72} See for example Pronina (2011).
\textsuperscript{73} Rauschenberger (2011). This includes for example the states of California, Florida, Oregon to name a few populous and ICT intensive states in the US.
3.3. Proposed solutions to identification problems

As we have discussed in section 2.5 in detail, there has been practical problems in getting proof of the consumer status (who) and at the same time places of taxation (where). Moreover, starting from 2015 the rule of origin principle will be changed to the destination principle for B2C e-commerce services transactions in the EU. Therefore, businesses selling e-commerce services cross-borders in the EU shall not only identify the consumer they are selling to, they shall also know the VAT rule applied in the destination Member State. However, the fragmentation of some of the common EU VAT rules and applications into 27 national systems will be the main obstacle for businesses to expand their involvement in Member States, for efficient intra-EU e-commerce trade and thus preventing from reaping the benefits of the single market. In this context three types of action are recommended.

3.3.1. Single point of contact for Information

The first practical solution to put in place is the availability of a single point of contact which provides common, accurate, reliable, and timely information on the details of the VAT regimes, rates and other related rules applied in Member States for business until similar rules prevail throughout the EU. Such single point of contact can be a web portal providing necessary information such as registration, invoicing, VAT return, VAT rates, special obligations and limitations to the right of deduction and others in several languages. The European commission has also acknowledged such solution by stating that:

"With the help of the Member States, the Commission will set up an EU VAT web portal. It invites Member States to confirm their willingness shown in the Tax Policy Group by making a commitment to provide the necessary information and to keep it up-to-date in a timely manner".\(^{75}\)

Such web portals shall also be in conformity with the information needed by businesses as of now, as well as in constant renewal for including the solution to the challenges identified by businesses in the Member States in the future. This may require multiple language versions.

We consider that the proper functioning of such a web portal offering focused, transparent and structured information on the application of EU rules across the EU (rates, guidance on application of mixed supply rules etc.) will be essential to reduce compliance costs for suppliers. In addition it will enhance efficiency and enforcement by tax authorities. Moreover, it is important that stakeholders become involved in the development and testing of the portal to ensure its usability in real business situations. Several language versions may be required.

3.3.2. Proposed solution to the identification problem of Who and Where

The ascertainment of a customer’s status (who) and the tax jurisdiction (where) are vital tasks for a business selling e-commerce services in the EU. This decision depends on whether the customer is a business or a private consumer and whether that consumer is established in the same tax jurisdiction with business or abroad (cross-border), see section 2.1 for more detailed information.

With the current country of origin principle, the EU\(^{76}\) B2C e-commerce service vendors who sell their services to private customers in the Member States are typically aware of the VAT rules and regulations in their place of establishment.


\(^{76}\) It is already the case for non-EU established business selling their service to EU customers.
However, come 2015 with the switch of origin principle to destination principle, identifying the location of private customer will be a central issue for such vendors. Moreover, traditional methods that can easily be used for identifying a customer who acquires goods might not be sufficient for tracing a customer acquiring services as of 2015. The European Commission\(^\text{77}\) has been considering a set of criteria that can possibly be used for identifying the consumer. Consequently, a concrete proposal on such issues is expected to come out by the end of 2012. Finding practical criteria, which can be used as a proof of customers’ status and location, as well as enforcing them uniformly across Member States is becoming crucial.

We will look into practical criteria proposed so far from two perspectives: identifying business customers (B2B) and identifying private customers (B2C). All the practical criteria to be discussed in this section can be seen as a base for tax authorities to provide clear, realistic and consistence guidance to businesses for clarifying the tax status and jurisdiction of a customer with the expectation that all parties involved would follow them in Good Faith.

**Identifying B2B consumers:** proving the tax status and jurisdiction of high value B2B transactions where the vendor and the customer have an established relationship will typically not be a problem\(^\text{78}\). This is due to the fact that the vendor is normally aware of the customers’ status and jurisdiction. However, the low value B2B transaction is the one which needs more attention in regards to identification of their status and jurisdiction. The set of criteria proposed to be used as guidance are:

- **Customer declaration:** this is a way of verifying customers’ place of residence through customers’ self-declaration of their status in addition with their place of residence. This can be an important part of the tax decision process for low value B2B e-commerce service transaction. However, as the reverse charge tax collection mechanism allows business customers to receive the services without being charged by the vendor, private consumers may have a financial incentive to declare they are a business. But a customer’s making a false declaration is an offence and liable to further punishment under law, which might reduce the above incentive, if not eliminate it altogether.

- **VAT registration numbers:** this is the way of identifying a business customer through communicating customer’s VAT identification numbers to the vendors who obtain confirmation of the validity of that identification number and the associated name and address. This is one of the main criteria currently applied in the EU for identifying the B2B service consumer.\(^\text{79}\) At present, in intra-EU supplies the customers, if VAT registered, will supply their VAT number to the vendor during the transaction. Where it becomes necessary for the vendor to check the VAT number provided, they can do this by reference to the VAT Information Exchange System (VIES).\(^\text{80}\)

\(^{77}\) To be clear the commission has not yet picked any specific criteria so far (form an interview of European Commission staff).

\(^{78}\) OECD (2002a), Electronic Commerce - Commentary on Place of Consumption for Business to Business Supplies (Business Presence), Consumption Tax Guidance series No.1, Centre for Tax Policy and Administration.


\(^{80}\) It is a mechanism whereby the vendor in the EU can check the validity of VAT registration number given by Member States but not name and address.
• **Payment system data**: this is a way of verifying customer status via the payment mechanism. However, it is highly unlikely that credit card information alone would be of assistance in determining the status of the business consumer in the meantime, as only minimal information about a cardholder would be passed onto a vendor for privacy protection reasons.81

• **Nature of Supply**: The nature of the supply may provide an indication of the consumer’s status. For example, supplies of digitised music or films, with no entitlement to the embedded intellectual property rights, might be indicative that the customer is not VAT registered and a non-taxable person. Even if the customer is VAT registered it is likely that the supply would be for personal use and not a business input. Using this same indicative approach, business accounting software is much more likely to be a B2B rather than a B2C sale. Even if the nature of the supply can offer reasonable presumptions there are limitations to this method of verifying the status of the customer. For example, it could be difficult to distinguish between anti-virus software sold to a private customer and the same software sold to a small business for business purposes.

• **Digital Certificates**: The use of digital certificates issued by vendors may help to determine the tax status of a customer for tax authorities. Tax authorities should however be able to recognise the authenticity and integrity of digital certificates. The integrity of such certificates includes consideration about who issued the certificate, how the information contained on the certificate was validated and whether there is scope to include particular information about VAT registration status and jurisdiction. If these matters can be addressed, this approach offers the best possibilities, because it can be conducted in real-time and with greater reliability than other methods.82 The Digital Certificate can both be used to verify that the customer indeed is a taxable person and, for a private customer, be used to verify the residence state to ensure correct application of destination rate see below in the B2C Section.

• **Guidance from local authorities**: Above all, in cases where the customer’s self-declaration is not in agreement with other indicia used to verify the declaration, revenue authorities should consider providing additional domestic guidance as to how to tax these transactions. Where the vendor cannot regard the customer as a business customer, because, for instance if the customer cannot provide a valid VAT number, this will lead to the presumption that it is a private customer and VAT should be charged accordingly. This is actually what is stated in the VAT directive in the EU: the supplier may regard a customer established in the Community as a non-taxable person when the supplier can demonstrate that the customer has not communicated his individual VAT identification number to him.83

Identification of business customers in the EU is mentioned to be a problem by some stakeholders in the interview; however, it is believed that the concern can be solved if Member States’ tax authorities work in close collaboration with vendors especially when the customer fails to provide a valid VAT registration or provides conflicting information, which is believed to the area of main concern by interviewees.

81 OECD (2002a), Electronic Commerce - Commentary on Place of Consumption for Business to Business Supplies (Business Presence), Consumption Tax Guidance series No.1, Centre for Tax Policy and Administration.


Identifying B2C consumers: Under normal circumstances, the place where the recipient is located will be the place where the recipient has his residence. And we believe that the place of residence will in general be the place where consumption usually takes place. This is true at least from the analogy of goods treatment. If a final consumer buys a paper book from the UK and gives a Danish address to the UK vendor for shipping purposes, the UK vendor will assume that the book will be consumed in Denmark, and hence if a destination principle has to apply, the Danish VAT will be charged. In reality, a Danish consumer might read the book in Austria while he/she is on vacation. We believe that the same treatment has to apply for services. The main challenge for services is, however, finding the residence of the private consumer. Even if the European Commission has not yet decided on specific criteria to call for, a range of criteria will have to be applied to determine the most correct place of supply when it is impossible or very difficult to ascertain where the residence is. Some studies such as the study commissioned by OECD suggested that a combination of criteria can be used to identify residence of private consumers. These criteria are:

- **Customer declaration**: this is a way of verifying private customers’ place of residence through customers’ self-declaration. However, such a declaration might be manipulated to achieve the desired outcome. Nevertheless, making a false declaration by the consumer is an offence and liable to further punishment by law, which might reduce manipulation of such declaration by the private customer;

- **Payment system data**: this is a tool of verifying customer status via the information used during the payment process. However, using credit card information alone might be insufficient in determining the status of the consumer, in the meantime, as only minimal information about a cardholder will be passed to vendor for privacy protection reasons;

- **Tracking/Geolocation software**: this is a method of determining tax jurisdiction of private customer based on user’s Internet Protocol (IP) address. To determine the jurisdiction from an IP number, the destination IP number is compared to a database of geographically known IP numbers. Internet experts have recently claimed that geolocation technologies achieve 85 per cent accuracy;

- **Nature of Supply**: The nature of the supply may provide an indication of the consumer’s status. A combination of features including language, content of the supply and currency may assist in providing indications of intended destination of supply;

- **Digital Certificates**: The use of digital certificates by vendors may help to determine the tax status of a customer. However, the use of digital certificates is less widespread among private customers than businesses. Hence, such an option might be considered in the long term to verify the residence country.

A combination of one or more of the above mentioned criteria can be considered for identifying the tax status and jurisdiction of digital services to private customers. It is important to note that a single criterion may not be good enough to precisely identify the tax jurisdiction of a private customer. The European Commission has also acknowledged this drawback and considered to propose a set of criteria for identifying the private customer, especially when it is impossible or difficult to ascertain the tax jurisdiction. The Digital Certificate could be relevant and helpful tool in this regard.

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86 Ibid.
87 Ibid.
Ultimately, it is a question of "Good Faith" behaviour. A vendor which has verified that the customer has provided a consistent set of data with IP addresses, validated credit card information as well as postal address of the customer all indicating residence in the same country should in general terms be considered as having completed a sufficient job in terms of identifying the country of destination.

Moreover, there needs to be a balance between costs of compliance for individual transactions and value of transaction. Tax authorities might justifiably require a higher level of verification of data provided for a transaction running into millions of euro than when buying an e-book of the cost of EUR 5. This will also apply to digitalised e-commerce based trade to the extent that the verification and treatment of data input from customers require some human intervention to identify the appropriate tax treatment.

Once the set of criteria for identifying both the status and place of taxation for the consumer have been put in place, there might be a need to store some of the data to ensure that in case of audit the supplier has the information to justify the VAT treatment. Assuming the need to store some of the data for each transaction, the question is which criteria need to be stored and how long. There has to be a practical solution for this and one way to do that might be to ensure that official procedures are put in place to check the criteria. However, the "good faith trust" aspect that the supplier will continue to apply the principles is required nevertheless.

Ultimately, we suggest that the EU, together with national VAT authorities could produce guidelines that define what good faith behaviour of vendors to apply the correct tax treatment implies in practice, according to different business situations. That should be of help also in the subsequent audit and enforcement of individual VAT transactions.

The more standardised and uniform across EU such Good Faith Guidelines can be constructed, the better the scope for keeping transaction costs low. What should be aimed for is trading interfaces that allow automated determination of appropriate tax treatment based upon standardised customer identification information. Required human intervention to complete a trade should be limited to either large scale purchases for B2C trade or inconsistent information being provided as discussed above (IP-address, physical address, credit card info).

3.3.3. Proposed solution to the identification problem of when in case of vouchers

The European Commission has been working on a proposal to amend the VAT Directive, which provides rules on the treatment of transactions involving vouchers.88 The purpose of this initiative is to harmonise to a maximum extent the VAT rules that apply to vouchers in Member States.

In the Commission proposal it is stated that “voucher” shall mean an instrument carrying a right to receive a supply of goods and services, or to receive a price discount or rebate with regard to a supply of goods and services, where there is a corresponding obligation to fulfil this right."89

The Commission’s proposal for a VAT treatment of vouchers in the Member States depends on its function. If a given voucher is to be considered as a “single-purpose”-used to purchase a specific kind of good/service in a single Member State, it will be taxed when issued. However, if a voucher is meant for “multi-purpose” or used to buy goods or services that are subject to different VAT rates (“open ended”), it will be taxed when redeemed.90

89 Ibid, Page 19
90 Ibid, pages 4 and 5
This distinction of voucher treatment hinges on whether the information is available to tax on issue or whether it is necessary to await redemption due to its multiple-choice nature.

We believe that such treatment of vouchers will help to reduce the uncertainty among vendors as to when to tax different vouchers across Member States.

### 3.4. Near term compliance models

Our review of shortcomings revealed that companies face considerable compliance costs following the practical application of national VAT rules linked to cross-border e-commerce transactions. We will review a number of options which can be in place in 2015 as required. The options are reviewed starting with a discussion of the scope and limits of proposed One-stop-shop and see how that can be taken further in the very near term. The European Commission has put forward options for more far ranging compliance systems as discussed in section 3.5, but it is widely accepted that they cannot be in place by 2015. So the options below are thus that could be in place by 2015.

#### 3.4.1. One-Stop-Shop: scope and limits

By using the destination principle, instead of the origin principle for B2C e-commerce service transactions starting from 2015, EU businesses providing digital services and trading in several Member States are concerned about the obligation to obtain a VAT registration in multiple countries. Such concern arises from the fact that dealing with several tax administrations and with multiple VAT obligations in different languages can be very burdensome and costly for businesses.

In light of reducing such an administrative hurdle, the European Commission, supported by the High Level Group of Independent Stakeholders on Administrative Burdens, proposed the so called One-Stop-Shop (OSS) scheme – a scheme whereby a business may opt to account for VAT across the EU via a single electronic declaration. Such a scheme has been decided to be available for B2C telecommunications, broadcasting and electronically supplied service providers established in the EU as of after January 2015. The scheme has already been operational for non-EU B2C electronically supplied service providers since 2003. The main purpose of the scheme is to simplify compliance requirements by avoiding the need for multiple-country VAT registration, which otherwise would be necessary.

The implementation of the OSS is the prime concern, given the fact that there is no practical experience of OSS as such in the intra-EU trade except for non-EU established suppliers of B2C electronically supplied services that have already started practicing it in 2003. The Commission has expressed such concern by stating that “The implementation of the mini OSS is seen by many Member States and by business as a major milestone. Its smooth functioning should pave the way for a more general use of this concept. However, given the lack of experience of an OSS for intra-EU trade, Member States appear to be somewhat reluctant to consider broadening its scope at such an early stage. The Commission remains convinced that, in a VAT system based on taxation at destination, an OSS is a crucial instrument to facilitate access to the single market, in particular for SMEs”.

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The Commission further stressed that “Ensuring the smooth introduction of the mini OSS in 2015 is a high priority for the Commission and it is relying on Member States to make the necessary resources available”.  

As currently contemplated the OSS consists of the possibility for an EU based digital service provider to appoint his Member State of establishment as Member State of identification for all his supplies made to EU countries where he is not established. The digital service provider will then file a single report with the respective Member State’s tax authority containing the consolidated tax data (turnover and VAT amounts) for supplies towards all EU countries. Also the payment of VAT amounts for all countries is made centrally by the service provider. The onward communication and payment of VAT amounts happens between the Member States’ tax authorities. A pending regulation proposal of the European Commission defines some common rules including the set of information that service providers need to keep on a transactional basis.  

Now, the question rises whether making the OSS available to EU businesses will indeed significantly reduce their new compliance costs as of 2015. We would note the following concerns:
- VAT reporting (and subsequent audit) data requirements are still substantially higher than for normal retailers;
- Furthermore, these businesses will still have to potentially face 27 national VAT audit teams;
- Even under the OSS, EU businesses selling digital services will still have to comply with 27 sets of VAT rules across the EU. The current lack of transparent information on these rules may be more burdensome than complying with the additional formalities themselves.

The resulting cost from the efforts required to follow up and reply to requests for information from home and destination country tax authorities should not be underestimated.

Several improvements could be made to tackle the aforementioned deficiencies to treat e-commerce vendors, which by nature have cross-border activity, in a way comparable to traditional retailers. Below we have outlined a number of initiatives that could deal with these three broad headings which could be operational by 2015:
- Option A: Uniform practice for reporting across types of retailers;
- Option B: Make supplier country responsible for audit;
- Option C: Apply VAT applicable in home country, except for VAT rate.

3.4.2. Option A: Uniform practice for reporting across types of retailers

Under this heading we have identified the following possible actions:
- Extending the OSS to digital selling;
- Allocation of VAT revenue on revenue not transaction basis.

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93 Proposal for a Council Regulation amending Implementing Regulation (EU) No 282/2011 as regards the special schemes for non-established taxable persons supplying telecommunication services, broadcasting services or electronic services to non-taxable persons, COM (2012) 2 dated 13 January 2012.

94 Proposal for a Council Regulation amending Implementing Regulation (EU) No 282/2011 as regards the special schemes for non-established taxable persons supplying telecommunication services, broadcasting services or electronic services to non-taxable persons, COM (2012) 2 dated 13 January 2012.
**Extended OSS also for distance sellers**

The extended OSS (taking into account the above considerations) should also be made available to distance sellers (B2C sales of goods by EU businesses).

On the one hand, distance sellers face similar problems compared to digital service providers:

- They have to comply with VAT rules of countries where they are not established. Allowing distance sellers to apply the VAT rules of their home country, except for the VAT rate, would considerably decrease their compliance burden;
- They have to report VAT on a transactional basis even if they sell low value goods (such as DVD’s). In the context of distance sales, the best criterion to be used is the “ship to” criterion for the allocation of the VAT receipts, rather than e.g. IP address or credit card data. Based on the shipment of the goods around the EU, it is very easy for distance sellers to allocate their revenue for VAT purposes.

On the other hand, there are some distinguishing factors which in our view should not subsist in a truly adapted VAT regime for e-commerce operators:

- In a number of countries, distance sellers have to issue invoices to their B2C customers who differ from the general acceptance around the EU where under B2C transactions can be booked for VAT on a cash accounting rather than on invoicing basis. It is doubtful whether this exceptionally stringent formal approach, which dates back to the abolition of fiscal frontiers in 1993, should persist in the digital age;
- Distance sellers have the benefit of a threshold which allows them to stay under their home country legislation until a certain level of sales. As from the first sale of digital services, an operator will have to charge the amount of VAT from the destination country, while a distance seller will be able to charge VAT from the home country as long as the threshold of the destination country is not surpassed. In the case of distance sales this may lead to optimisation schemes.

*Example:* Two retailers operate an online business of EUR 25,000 per year and are active on the Belgian market. One of them is established in Luxemburg, the other one in Belgium. Under the assumption that all goods are sold to Belgian customers, the Belgian retailer will have to charge 21% Belgian VAT, while the Luxemburg retailer will be able to charge 15% Luxemburg VAT (sales volume of EUR 25,000 < sales threshold of EUR 35,000).

Allowing distance sellers to apply the VAT rules applicable in their home country, except for the VAT rate, would not only relieve them from compliance costs but would also make the use of thresholds obsolete and avoid unfair competition arising from the existence of these thresholds as illustrated above.

**Allocation of VAT receipts on revenue basis rather than on transactional basis**

From 2015 onward, EU businesses providing digital B2C services will have to set up a customer identification process in order to support the allocation of their VAT receipts. Under the current VAT system, the VAT due is determined on a transactional basis. In this respect, article 1(2) of the VAT directive states: "On each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly after deduction of the amount of VAT borne directly by the various cost components."
This process implies that e-commerce operators will have to allocate VAT to the country where the customer is located on a transaction-by-transaction basis. Such a process may be very burdensome, especially for companies selling digital services for a single and small price across the EU. Some of these companies realise more than one million transactions a day and will be forced to document customer information for all these separated transactions.

Example: An e-commerce operator established in Cyprus sells e-music for EUR 1 per download. The company realizes more than 1,000,000 downloads per day, of which 100,000 in Belgium, 300,000 in France, 500,000 in Germany and 100,000 in Luxemburg. Today, the company will report 15% Cypriot VAT for 1,000,000 transactions. Under the 2015 rules, 21% Belgian VAT, 19.6% French VAT, 19% German VAT and 15% Luxemburg VAT will be due for 100,000, 300,000, 500,000 and 100,000 transactions respectively. Moreover, the company will have to document all these transactions by storing detailed customer information.

In this respect, it should be considered to allow EU businesses to allocate their VAT receipts on a gross revenue basis, rather than on a transactional basis. Under such a model, a company would be able to limit its customer identification process through a proxy identifier for the country of the customer, e.g. by tracking the country related to the IP address or credit card used for making the purchase. Based on the number of transactions per registered country, the turnover would then be allocated to these countries and the respective VAT would be extracted, reported and paid.

Example (continued). The company is able to substantiate sales for EUR 1,000,000 of which 10% can be allocated to Belgium, 30% to France, 50% to Germany and 10% to Luxemburg, based on IP tracking. Under such a scenario, it would be very easy for the company to calculate, on a periodic basis, the VAT due in the various Member States.

Indeed, when comparing e-commerce providers (particularly in B2C) with domestic vendors of similar products, the former are confronted with a complexity caused by the cross-border dimension of their trade, requiring a substantial splitting of their revenues into the correct VAT categories. On a domestic level, retailers have a similar issue if they are selling products belonging to both high rate and low rate categories. For such situations, simplified approaches nowadays already apply to the traditional retail sector in many EU countries. In particular, through so-called standard or bespoke retail schemes by allowing retailers to allocate their (domestic) turnover to different VAT rates through apportionment methods, point of sale methods, etc.

This option could be seen as a precursor for future collection schemes as discussed in section 3.5 such as data warehouse systems where all individual transactions are being stored at company level with the option of the national tax authority to request it ("limited" version) or at centralised level with immediate access for tax authorities ("centralised" version”).

3.4.3. Option B: Make home country responsible for audits

Today, EU digital service providers file VAT returns and pay VAT due in their home countries, as VAT is due in the country where the supplier is established. The compliance process (reporting + auditing) covering activities within 27 Member States is completed within their home country.

In the framework of the OSS, non-EU digital service providers can file VAT returns and the VAT due in the various Member States through a single EU country. In this respect, the non-EU vendors only have to face the VAT authorities of the “registration” country for
reporting purposes (e.g. obtaining VAT number, filing VAT returns, etc.). But they still have to face the VAT authorities of all “destination” countries for audit purposes (e.g. request for information, investigation of bookkeeping, etc.). More upstream, the need to meet local requirements of the destination countries at an audit level necessitates the implementation of local rules and formats in the setup of the compliance model that supports the (summary) reporting. Thus, the simplification under the OSS only covers the reporting part of the compliance process, not the auditing part.

Example: A German company and a Japanese company sell online movies in selected EU countries. The Japanese company opts for Germany to be its registration country. Under this scenario, both companies will be able to report the VAT due on their transactions via a single VAT return to be filed in Germany. The submitted information of the German company will be audited by the German VAT authorities, as German VAT is due on all its transactions up to 2015. The submitted information of the Japanese company will however be transferred to the destination countries and each of them will audit part of the information received, as part of the transactions will be subject to VAT in their country. In case of questions, the German VAT authorities will address their questions to the German company, while the VAT authorities of the destination countries will address their questions directly to the Japanese company. The Japanese company is thus supervised by multiple Member States at the same time for VAT purposes, while the German company is only subject to VAT audits in one EU country.

The scheme applicable to non-EU based B2C digital service providers will also become available for EU-based companies, as of 2015. Taking into account the lack of harmonisation of the VAT auditing rules in the EU (e.g. different prescription rules, different VAT audit approach, different VAT bookkeeping requirements), EU businesses expect the change from the home country rules to the destination country rules to have a considerable negative impact on their compliance burden (e.g. multiple and overlapping requests for information, lengthy VAT audit processes, double taxation).

EU businesses selling digital services or performing distance sales should not be confronted with 27 national VAT audit teams. Mostly, these companies have no physical presence in other countries than the one in which they are established making audits very burdensome (differences in language, bookkeeping methods, etc.). Moreover, national VAT audit teams may disagree on certain items, for example the allocation of a part of the turnover, potentially resulting in double taxation. Thereby, they move from being supervised by one national authority to being supervised by 27 different VAT authorities at the same time.

Example: An e-commerce operator selling mobile apps realizes EUR 1,000,000 turnover in the EU and allocates 40 per cent to customers established in France, 40 per cent to customers established in Germany and 20% to customers in Luxembourg, based on the billing addresses linked to the mobile phones. In 2012, the Luxemburg VAT authorities perform a VAT audit over the period 2010-2011. In 2013 the same period is investigated by the French VAT authorities. In the framework of their VAT audit, the French VAT authorities contest the customer information gathered on the sales realized in Luxemburg and claim additionally French VAT on 20 per cent of the turnover. The Luxemburg authorities do not agree with the position of the French VAT authorities and are not willing to refund the VAT paid. In such a scenario the operator is confronted with two investigations resulting in double taxation on 20 per cent of its turnover. From an EU VAT perspective it is possible that part of the turnover should be reallocated, but then resulting in a VAT payable in one country and at the same time in a VAT receivable in another country.
In this respect, the following policy options should be considered:

- Appoint the home country of the vendor as single point of contact for the VAT authorities of the destination countries. Thereby, the vendor will no longer be confronted with 27 destination country authorities. The home country authorities will mostly be able to answer requests for information within a short time frame based on vendor information available in its audit file. Such an approach should avoid multiple and overlapping requests for information and lengthy VAT audit processes;

- Install mixed VAT audit teams whereby several officials of the home and destinations countries perform a single VAT audit whereby in mutual agreement they decide which corrections have to be made. Such an approach should also avoid double taxation;

- Replace the VAT audits performed by the destination countries by one VAT audit performed by the home country. The results should then be transmitted by the latter to the former. Under such scenario, the home country would not only act as a single point of contact but also as a single point of audit. In this way the auditing part of the compliance process would be fully streamlined with the reporting part, and a major simplification under the OSS would be achieved.

3.4.4. Option C: Apply VAT rules applicable in home country, except for VAT rate

As from 2015 VAT onwards digital B2C services provided by EU businesses should be allocated to the country where the customer is established. Only two essential parameters determine the tax result for these transactions:

- the country where the customer is located\(^{95}\), and
- the applicable VAT rate.

In this respect, it should be considered to allow EU businesses to apply the VAT rules applicable in their home country under the OSS, except for the VAT rate which would still be determined by the destination country of the customer. Applying the VAT rules of the destination country in order to determine the chargeable event, for instance the taxable amount, has no added value in this context. The chargeable event for example should be the moment of collection of the VAT charged on the transaction in all Member States. EU businesses are familiar with these rules in their home country and should be able to apply them in a cross-border context as well. Thus, their search for information is limited to VAT rates, thereby considerably decreasing their new compliance costs.

Applying the VAT rules applicable in the home country would also solve a series of problems of which we have summarized some examples below.

**Scope of digitally supplied services**

An issue that we have discussed in section 2.5.5 relates to the lack of a straightforward definition for digitally supplied services. Without a clear and binding definition of digital services in the EU, Member States might treat the same product differently, and hence businesses will have a problem of complying with divergent VAT rules across the EU. Until 2015, this mainly remains a national problem due to the origin principle applicable on cross-border sales, which "only" requires suppliers to understand and apply the rules from the country where they are established. As of 2015, suppliers need to understand the scope of digital services as interpreted and applied in 27 different Member States.

\(^{95}\) I.e. where the customer has his permanent address or usually resides, ref. Directive 2006/112/EC on the common system of value added tax, as regards the rules on invoicing, article 59.
The compliance costs related to this problem can be avoided by allowing EU businesses to apply the VAT rules applicable in their home country based on the OSS. At first sight, such a measure may create competition among the Member States, as one Member State may dispose of a more beneficial interpretation of the scope of digital services than another Member State, and therefore attracting e-commerce businesses. However, this threat should be considered to be an opportunity, as these situations reveal those areas where there is a need for more clarification. After all, as the definition of digitally supplied services is already laid down in a European Council Implementing Regulation, which has a direct effect on the Member States and which per definition solves interpretation problems; one may expect that new interpretation problems are dealt with at EU level.

**Currency conversion rules**

The VAT amount due for the supply of goods or services is required to be reported in the currency of the Member State where the supply takes place. However, given the fact that various currency conversion rules apply across the Member States, it is an obstacle for cross-border e-commerce operators to determine the exact VAT amount that is due to the countries where their respective consumers are located. This is what we have identified as the so called *what price* problem in section 2.5.4.

Article 230 of the EU VAT directive states that “The amounts which appear on the invoice may be expressed in any currency, provided that the amount of VAT payable or to be adjusted is expressed in the national currency of the Member State, using the conversion rate mechanism provided for in Article 91”.

Article 91(2) of the EU VAT directive further states that "Member States shall, instead, accept the use of the latest exchange rate published by the European Central Bank at the time the tax becomes chargeable. Conversion between currencies other than the euro shall be made by using the euro exchange rate of each currency. Member States may require that they be notified of the exercise of this option by the taxable person. However, for some of the transactions referred to in the first subparagraph or for certain categories of taxable persons, Member States may use the exchange rate determined in accordance with the Community provisions in force governing the calculation of the value for customs purposes”.

Based on the above, e-commerce operators should be able to use the exchange rate published by the ECB as a common conversion mechanism in the Member States. This option is meant to reduce the administrative burden for businesses performing cross-border transactions. However, these dispositions will impose problems for e-commerce operators as from 2015:

- They will still have to verify in the various destination countries whether the Member States have transposed this option in their national legislation. If that is the case they have to determine whether they have to notify the use of the option to the local VAT authorities, which is quite burdensome as already explained above;
- They will still have to verify the exchange rate *each time* VAT becomes chargeable on a sale, which is quite burdensome for an industry where high volumes of transactions take place on a daily basis.

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Taking into account the importance of clear and easy-to-apply currency conversion rules for cross-border e-commerce operators, these problems can be fully avoided by allowing EU businesses:

- to apply the VAT rules applicable in their home country under the OSS;
- to use a monthly average exchange rate or use the exchange rate published on for instance the last day of each month.

**Mixed supply issues**

Mixed supplies of e-commerce goods and/or services, e.g. paper and digital format of a newspaper, pose challenges with respect to the determination of the VAT due. The VAT treatment of mixed supplies may considerably differ across Member States. Such variation may create an obstacle for vendors engaged in cross-border e-commerce business and may ultimately increase their compliance costs.

*Example: In case of mixed supplies, the Belgian VAT authorities have published the following guidelines:*

- If the value of the supplied and installed goods is *lower than 50 per cent* of the total price due by the customer to the supplier, the supply qualifies as a supply of services;
- In other cases, the supply qualifies as a supply of goods.

The Dutch VAT authorities however take the position that the aim of the purchase from the customer's perspective should be taken into consideration in order to qualify the supply as either a supply of goods or a supply of services.

One way to reduce the compliance cost related to mixed supplies is to convert the judgements of the European Court of Justice in this area into concrete guidelines laid down in a VAT implementing regulation. This could be realised in cooperation between the European Commission and Member States for example resulting in an opinion of the VAT Committee. In this way e-commerce operators will have a single source of information to determine the actual VAT treatment of mixed supplies across Member States.

Preparing a VAT implementing regulation based on case law for mixed supply issues will take some time and can be considered as a long term solution. Pending such an agreement, the compliance costs related to this problem can be avoided by allowing EU businesses to apply the VAT rules applicable in their home country under the OSS.

**E-Invoicing and E-filing**

Electronic tax systems for filing and paying taxes reduce the compliance burden both in terms of time and cost. Based on a sample of countries practicing e-filing and e-taxing systems, a VAT compliance time in such countries has been reduced by 30 per cent.97

Even more administrative burden reductions can be achieved through a full application of e-invoicing in the EU countries98. Council Directive 2001/115/EC introduced common EU rules on VAT invoices to ensure a proper and clear functioning of the internal market in relation to invoicing rules across the Member States.

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97 PWC (2012); Paying taxes 2012; The global picture (http://www.pwc.com/gx/en/paying-taxes/index.jhtml)
In general, the rules on invoicing are those applicable in the Member State where the tax is due. However, this general acceptance of the prevailing rules of the country where the tax is due presents certain difficulties for businesses. Moreover, such application has allowed Member States to maintain different rules on invoicing. A taxable person making supplies on which the tax is due in another Member State has to meet that Member State’s conditions on invoicing. In cases where the supplies are subject to the reverse charge mechanism, the supplier must meet the invoicing rules without even being required to be identified for VAT in the Member State where the tax is due.\textsuperscript{99} Given the basic rule that the place of taxation of B2B e-commerce supplies is where the customer is established, this problem is more acute now.

The many options available to the Member States have led to various sets of invoicing rules. This can clearly be seen in relation to the different rules in place for e-invoicing, and is generally regarded as one of the barriers to increased use of e-invoicing. For example, there has been a pre-condition for sending electronic invoices such as requiring either advanced electronic signature or electronic data interchange (EDI) along with the various options and interpretation afforded to Member States. This condition makes e-invoicing difficult to implement, especially across-borders.

Taking the above invoicing problem into consideration, the European Council has passed a directive amending 2006/112/EC on the common system of value added tax as regards the rules on invoicing.\textsuperscript{100} These new rules will be applicable in the Member States as from 2013.

It is important to note, however, that even if the amending directive addresses most of the issues such as treating paper and e-invoicing equally and avoiding any pre-condition set for using e-invoicing, for instance advanced electronic signature or electronic data interchange (EDI), there is still the option left for Member States to decide whether an invoice is needed for B2C transactions. To the extent that this option remains to exist\textsuperscript{101}, this provision may be implemented differently in the Member States. Therefore, we believe that this invoice requirement should be abolished.

We understand, however, that the Commission is well aware of this yet unsolved issue, and recognises the need to deal with this at a later date.

Pending a workable solution, it could be an alternative to allow home-country rules to apply as well in this area.

\textsuperscript{99} This will not be there after 2013 as the reverse charge supplier will be able to apply rules of her/his home country (Council Directive 2010/45/EC (New article 219a(2)(a))


\textsuperscript{101} It does not mean there have not been pre-conditions for invoicing, the issue is that it has to be harmonised across Member States to the extent possible so that there will not be additional burdens for business complying with such pre-condition in the Community.
3.5. Collection models for the future

3.5.1. Preliminary findings

VAT has always been collected in the same way since its introduction in the European Union. Throughout the production and distribution chain, VAT is managed and paid by suppliers, while national VAT authorities are responsible for the supervision of the VAT collection process.

The VAT collection process (also covering compliance, reporting and audit) set up over time has mainly taken financial reporting obligations at company level as a starting point for the development of VAT reporting obligations, resulting in businesses nowadays fulfilling their VAT reporting obligations mostly based on information derived from their financial reporting systems (e.g. sales and purchase ledgers).

The current VAT collection model is thus clearly driven by businesses’ financial reporting systems and not the other way around. Therefore, any new VAT collection model put forward will have to be able to adapt itself to the business environment, especially financial reporting practices, rather than that businesses should redesign their financial reporting processes following new VAT reporting obligations. Otherwise, the new VAT collection model may be too costly (both in terms of implementation and ongoing operations), and may not achieve the hoped-for benefits.

Finally, the measurement of the administrative burden specific to VAT reporting obligations in the framework of the European Commission’s ‘EU Administrative Burden programme’ has shown that VAT is the most burdensome legislation out of 13 selected domains. VAT accounts for EUR 79.5 billion, or 62.7% of the total costs.102 The costs of VAT are largely due to three information obligations relating to VAT bookkeeping, to the submission of periodical VAT returns and to the issuing of VAT-compliant invoices.

3.5.2. Discussions at EU level

As part of the ongoing debate on the strategy to combat VAT fraud, which questioned the efficiency of this collection method, in 2009 the Commission launched a feasibility study on ways of improving and simplifying the collection of VAT by means of modern technologies and/or via financial intermediaries.

In the framework of the Green Paper103 and subsequent White Paper104 of the European Commission on the future of VAT, several new VAT collection models were put forward. However, none of them could count on broad support of the business community. Amongst others, they were not convinced that these models would actually reduce the VAT gap.

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The comments received by the Commission on VAT collection models following the consultation on the future of VAT obviously affects all VAT collecting businesses and goes beyond the interest of e-commerce businesses. Taking into account the specific environment in which e-commerce businesses operate, we believe it is worth to further investigate the proposed VAT collection models from their perspective. E-commerce businesses may have an important pioneering role to play in this respect. Moreover, to our knowledge, the VAT gap in e-commerce has not yet been investigated. We expect that the VAT gap in this industry will mainly result from activities of non-EU established companies operating in the EU as the enforcement of the VAT rules on these companies is far from evident.

3.5.3. Real time VAT collection based on split payments

Under this model, the customer would instruct the bank to pay for the goods or services, and the bank would split the payment between the amount paid to the supplier and the amount paid to the VAT authorities.

At first sight, this VAT collection model seems to be very promising, for all involved parties:

- Governments could reduce the administrative burden for businesses and cut fraud relying on financial intermediaries being trustworthy collection partners;
- Suppliers would benefit from reduced reporting costs due to the immediate payment of VAT and the granting of refund requests electronically;
- Financial intermediaries would be able to generate new business.

However, the full benefits of a “real time” system would only be realised once the entire EU common VAT system had converted to a real-time technology based model. Moreover, immediate areas of concern include:

- Who pays for and provides the infrastructure needed?
- How will information flows be managed?
- How will data be secured?
- How will non-electronic payments (i.e. cash payments) be dealt with?

The question now rises whether the benefits of such a system may outweigh its disadvantages for e-commerce operators. We believe that this may be the case taking into account that:

- E-commerce businesses already operate in a digital environment making them familiar with real time information processing;
- They are used to manage substantial IT infrastructure, elaborated information flows and data security;
- Cash payments are no obstacle in the e-commerce environment;
- Many online payments are already settled via financial intermediaries;
- The one-stop-shop applicable as from 2015 offers an interesting platform to test this VAT collection model.
Of course, there are also some hurdles to be overcome:
- E-commerce operators would be forced to rely on a real time payment collection facilitator who is accredited by the European VAT authorities. While banks, payment service providers but also telecom operators should fit into this picture, it may reduce the flexibility for e-commerce operators to appeal to innovative payment providers. The need to involve accredited operators may drive up costs and complexity for e-commerce providers to do online business in Europe as compared to other jurisdictions;
- Output tax would become payable immediately, whereas input tax would (presumably) be credited under existing rules, following the end of the taxable period. This could raise cash flow issues;
- Finally, the VAT collection heavily depends on the good functioning of IT systems which may lead to adverse consequences in case of system failure. Therefore, a backup plan should be worked out.

This model may effectively reduce the VAT gap in e-commerce, albeit with a significant cost. Amongst others, non-EU established companies operating in the EU may be forced to use an EU real time payment collection facilitator for their transactions.

3.5.4. Central VAT monitoring database and VAT data warehouse

Under these models, all invoice data would be sent in real time to a central VAT monitoring database, or predefined transaction data would be uploaded and presented in an agreed format into a secure VAT data warehouse maintained by the taxable person and accessible, either directly or on demand at very short notice, to the tax authorities.

If one of these models would be implemented at EU level, we believe it could work especially for e-commerce operators if it implies that:
- The e-commerce operator would only have to submit the requested information once, and thus not in 27 separate databases/warehouses;
- The information would be centralised at EU level or at the VAT authorities of the country where the one-stop-shop is located (digital service suppliers) or their business seat is established (distance sales operators).

Such models could also enhance more efficient VAT audits to the benefit of both e-commerce operators and tax authorities:
- Uniform approach all over the EU;
- A single point of contact between both parties.

However, also under this model, there are some obstacles to be tackled:
- Despite developments in technology, these models face a high risk in terms of implementation. The recent amendments to the VAT refunds procedure illustrate the risks. The initial implementation date of 30 September 2010 had to be postponed until 31 March 2011, as a number of Member States did not launch their web portals for this procedure until quite late, and others had technical problems. Proposals for databases and warehouses may face similar issues;
- In terms of privacy concerns, the different data protection requirements in Member States may make the data warehouse proposal difficult to regulate and administer.

These models will be less effective in reducing the VAT gap in e-commerce. It will be difficult to force non-EU established companies operating in the EU but not complying with EU VAT obligations to submit the requested information.
3.5.5. Increasing the use of e-government solutions

Notwithstanding the fact that the above VAT collection models have the potential to improve, and possibly simplify, the way VAT is collected in an e-commerce environment, it remains to be seen whether the tax authorities would be capable of setting up such models in a reasonable time frame, taking into account the human and financial efforts needed.

As we have seen many times in recent history, some Member States are better equipped and prepared to actually implement these rather more IT-driven solutions and safeguard them than others (a recent example being the new VAT refunds process).

These views are also supported by the experiences with the realisation of the modernised customs code, these models cannot be expected to be implemented fully in the near future.

Partly as result of such considerations, a study for the European Commission proposed to go for so-called “limited” warehouse solution whereby firms are required to provide a standard audit file on request as opposed to sending it automatically to a central warehouse. This would avoid building the central warehouse from the start. This could later then be combined with the split payment model. But even this more limited model is estimated to be only operational from 2018 for the “limited” warehouse part and from 2010 for the split payment system. Moreover, this would require that decisions to implement such decisions were already taken and started in 2011 which they are not.

Such a combination of models could lead to very sizeable reductions in the identified VAT gap over time. Calculated on a net present value basis (NPV), the VAT gap could be reduced by EUR 1,782 billion to 2,391 billion over the entire period from the reforms are implemented in 2020 and the next 18 years. Subtracting costs of implementation, gains could range from EUR 1,574 to 2,038 billion, also on a NPV basis. This translates into yearly VAT gap reductions of EUR 82 billion to 107 billion. This is to be compared with the present estimate of the VAT gap of EUR 119 billion in 2009. Baring in mind the necessarily heroic assumptions underlying the estimates, a prudent conclusion would be that improved payment and collection mechanisms could provide a very significant contribution to public finances in the EU.

Table 6: VAT revenue and implementation cost from split payment and the “limited” data warehouse model, over period 2016 to 2038, EU27 estimates, billion EUR

<table>
<thead>
<tr>
<th></th>
<th>Minimum effects from reforms</th>
<th>Maximum effects from reforms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduction in VAT gap NPV</td>
<td>1,782</td>
<td>2,391</td>
</tr>
<tr>
<td>Total investment and operational costs, NPV</td>
<td>207</td>
<td>353</td>
</tr>
<tr>
<td>Reduction in VAT gap net of investment and operational costs, NPV</td>
<td>1,574</td>
<td>2,038</td>
</tr>
<tr>
<td>Approximate reduction of yearly VAT gap net of implementation costs1)</td>
<td>83</td>
<td>107</td>
</tr>
</tbody>
</table>

Note: 1) the reduction is calculated very roughly as NPV divided by number of years with the system fully implemented in the model calculations which are from 2020 to 2038 i.e. 19 years.

Source: PwC (2010), page 251-252

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Considering the above, we take the view that a combination of more straightforward measures on this moment would likely improve the efficient and effective collection of VAT.

For e-commerce businesses, introducing a common set of rules on VAT reporting and bookkeeping requirements within the EU, as well as minimising these requirements, is most important, taking into account the 2015 changes. The One-Stop-Shop is already an appreciated effort in this respect, however does not go far enough, especially with respect to VAT audits harmonisation, as part of the VAT collection process.

Being able to use the same systems and processes in all Member States to produce a standardised set of output data would be seen as a major step forward, even if harmonisation meant that additional data might need to be collected in some Member States which are currently less formalistic.

At the same time, EU institutions should try to reach an agreement on one of the new VAT collection models to be implemented in the framework of the one-stop-shop for e-commerce operators. Once such a model is successfully tested and implemented, it can be rolled out to other businesses.

As a final note, we also want to highlight the link between the need to improve VAT collection systems if the full benefits are reaped in the modernisation of the Customs code.

3.6. Summary

The review of reform options has been reviewed under three main headings:

- VAT rate setting;
- Identification of customers;
- Compliance with given rules

On VAT rate setting, the European Commission in 2012 has launched a new review and identified three priorities. These are to safeguard the internal market, underpin adopted EU policies inter alia in health and the environment and finally ensure like VAT treatment of like products and services.

We support these principles and discuss ways to implement them over the coming years. We underline first of all that equal treatment of physical and digital version of like products should be priority number one in this context. The unequal treatment embodied in the current VAT directive leads to distortions to the internal market, limits the environmentally friendly advantages of digital goods vis-a-vis physical variants and simply distorts consumer choice. It is also at conflict with underlying objectives which motivated the use of reduced rates on cultural or other merit based products, namely to make such products, for example books, affordable for a wider population.

We discuss essentially two versions of this policy: either standard rating of all e-commerce products or services or a reduced rate for both. We underline the wider context required to make such choices. First, if broader VAT rate reforms are undertaken, such as abolishing the reduced rates in areas where they lead to large revenue losses, then the standard rate can be lowered and hence prevent a substantial increase in VAT rates on the physical variants. Second, the application of the destination rate to digital services will be a challenge in the global context. Key trading partners impose lower sales taxes in general, with many US states imposing no tax at all on digital services.

The European Commission’s attempt to ensure equal VAT treatment for like type of digital payment services is also to be recommended. Given slow progress on the proposed directive on financial services that deals inter alia with this issue, we propose that the
European Commission could push this issue forward by way of guidelines, essentially codifying the existing jurisprudence of the Court of Justice of the European Union. On postal services, there are currently no specific proposals on the table: dealing with the VAT distortion.

**As regards identification of customers,** the European Commission has started the work. We agree on the need to build on the OECD work on taxation of e-commerce also in the view of ensuring a global approach. We see the main problem in terms of identifying the residence country in B2C transactions. While no single indicator alone will suffice to establish residence, a way forward would be that European Commission with the Member States establish a Good Faith Guideline: if traders follow this then they can consider themselves in good faith in subsequent audits. This could significantly reduce compliance costs inter alia by encouraging EU wide ICT solutions and effective VAT collection.

**On compliance models,** we analysed the options in two steps. What are options for 2015 and what could be in place towards the end of this decade?

As regards the 2015 options, we reviewed the "One-Stop Shop" solution proposed by the EU-commission but suggested that reforms could go much further to reduce compliance costs. We outline three levels of ambition (Options A, B, C) which in increasing order of ambition would include that reporting requirements were made more uniform across retailers; that home, not destination, country tax authorities were responsible for auditing; and that home country rules were applied also in cross-border situations including mixed supply issues.

Beyond 2015, the proposals from the European Commission to reduce compliance costs and improve effective collection – for example the split payment system and limited data warehousing – should be seriously reviewed. Estimates suggest that a combination of these two models could close the bulk of VAT gap of EUR 119 billion per year. Given the already high level of digitalisation of e-commerce, this could prove a good test case.
4. RECOMMENDATIONS FOR VAT TREATMENT OF E-COMMERCE

Our line of recommendations falls within three main areas:

- priorities for the review of the EU legislation on VAT rates (section 4.1)
- implementing the destination principle for all B2C e-commerce (section 4.2)
- how operators and tax authorities should comply with the rule set in practice in terms of VAT collection, reporting, auditing etc. (section 4.3)

4.1. Setting VAT rates

Under the heading of setting VAT rates, we have five priorities:

I: More common thresholds for applying destination country VAT rates to distance selling (EU cross-border e-commerce in goods). In this area the destination principle has been in play for many years. Given the fact that there is a physical transfer of goods across borders with delivery carried out by professional transport firms who have a reputation to protect, we find that the present rules are working. However, the thresholds for cross-border sales of goods that determine whether individual vendors are obliged to impose destination based VAT rates on their sales varies substantially between Member States. This provides a source of distortion of competition. We propose common thresholds or at the very least a move towards more common threshold values.

II: To abolish the difference between physical and digital variants of a range of products relevant for e-commerce. In this respect all the three priorities outlined by the European Commission in its communication point in this direction: neutrality between different product variants, commitment to resource efficiency (avoiding tax advantage for print version) and the functioning of the internal market.

We have reviewed two ways of doing this:

- Standard rating for basically all paper based media outlets along with their digital variants. To avoid substantial increases in VAT rates on politically favoured objectives such as accessibility to books in any form, such a move would be much facilitated by broader VAT reforms that would allow for substantial reductions of the standard rate in many countries.

- Reduced rates on both physical and digital content providers. This option is particularly relevant given he increasingly global nature of digital e-commerce trading. Given the EUs high overall levels of taxation, including higher sales/VAT rates, compared to a number of our trading partners, enforcing the destination principle only on trade between suppliers and customers within the EU may potentially push the supply of digital e-commerce trade towards suppliers outside the EU.

III: Review the advantages and disadvantages of such alternative scenarios where digital and physical variants are both taxed at either standard or reduced, preferable uniform, rates across the EU. Key issues to be analysed are:

- How large are tax losses resulting from reduced rates instead of standard rates given reduced “leakage” of particular digital content services to countries with low or zero sales taxes?
What prospects are there for getting the necessary co-operation with trading partners to ensure the destination principle for taxation on digital content services on a reciprocal basis?

What are the resulting effects on compliance costs under alternative scenarios for both rate setting and rules for collection, reporting and audit (as discussed in sections 4.2 and 4.3)?

IV: Review alternative mechanisms for serving the cultural and educational objectives that motivate the use of reduced rates for e-commerce related cultural and educational products and services. Emerging and broader trends in the area of the public and private media and communication industries are increasingly challenging the effectiveness of reduced VAT rate to further such aims (reduced VAT rates for certain types of broadcasting an example). Instead of VAT rate reductions applying to particular channels of communication (printed books, paper version of newspapers), specific support could be given to production of media content that serves identified public interest purposes.

V: Ensure more uniform and market neutral VAT treatment of e-commerce related services across the EU. Postal and financial services as well as mixed supply issues have been identified as being particularly problematic for the operators as well as distorting the functioning of the internal market.

In want of “hard” legislation to ensure such results, with relevant legislative proposals being blocked in the negotiation process, ”softer” guidelines could push Member States towards practices that are non-distorting and uniform. In additional to financial services, this is an agenda that can also be pursued more broadly for example in the area of mixed supply of services. There is a substantial body of case law from the EU court of justice that can be used for this purpose.

4.2. Guidelines/codes for common interpretation of VAT concepts and agreements

The move towards the destination based principle for B2C digital service transaction presents a substantial challenge for tax authorities in terms of effective enforcement. While for traders the challenge stems from heeding of compliance burdens and possible uncertainty about what precisely they should do in order to be acting in good faith towards tax authorities.

Under this heading, we have three priorities:

I: Effective dissemination of operational information. Make available by way of well-functioning web portals, operational information about the application of the VAT rules in Member States. As long as Member States are allowed to apply a diversity of reduced rates and exemptions on products and services relevant for e-commerce trade, the web portal will need to contain a wide range of information.

In addition to information about rate structures, it also needs to cover guidance on how such rules are applied in practice across countries. For such web portals to be effective and useable in practice they need to be tested extensively by market participants in advance of the application of the new rules.
II: Move towards the establishment of what the European Commission has termed a common VAT Code. That is essentially binding rules determining how to apply VAT in the community consistently based on the destination rule principle. The VAT Code will not be adopted in the foreseeable future but the European Commission can, systematically across a range of areas, push this agenda forward. A possible and feasible agenda is to get Member States to commit progressively to joint principles and common implementation in a number of areas which can then at some time be consolidated into an overall agreement forming the new VAT Code.

We have in this study highlighted a number of areas where this approach is needed and could be of help.

III: Establishment of Good Faith Guidelines. Essentially vendors in supplier (origin) countries now become the tax collectors for destination countries for digital services provided to private consumers. Non-taxable customers have an incentive to claim taxable status to obtain zero rating of cross-border sales. In addition, non-taxable customers have an interest in being designated as residing in a country with a low standard VAT rate: top to bottom differences in standard VAT rates within the EU is 10 percentage points. More generally, vendors need to know what justified criteria tax authorities can assume when auditing their books with respect to what they have done to verify the tax status and residence country of the customer. In Chapter 3 we proposed some elements that could be included in such Good Faith guidelines to reduce compliance costs inter alia by improving the scope for EU wide ICT solutions.

4.3. Compliance models: next steps

The EU needs more simplified rules and procedures applying to vendors dealing with tax authorities. After the transaction – a product/service is sold to the customer – the vendor is obliged to keep records to prove to tax authorities that the appropriate VAT rules have been applied and ultimately that the respective VAT has been received by the destination countries. As stated above, the vendor is effectively becoming a tax collector for tax revenues to tax authorities in other Member States. We recommend first that the auditing is based on Good Faith Guidelines. The vendor shall document that he/she is following "Good Faith" guidelines determined at EU level. Secondly, we recommend that liability for VAT rests ultimately with the vendor or his agent that "closes" the deal, i.e. accepts that the customer has provided the appropriate information of identification and verifies payment information (credit cards etc.).

For the operation of the system from 2015, we have rolled out three basic sets of options, increasing in the level of ambition with respect to making life easier for businesses and tax authorities and in turn allow more automated information exchange:

- **Option A** takes as its basis the European Commission one-stop-shop proposal which allows cross-border e-commerce vendors the option of sending information about completed cross-border trades to the relevant (up to 27) tax authorities through just one tax authority and report. The option will still require that the vendor keeps records on a transaction basis that can be requested by the foreign authority. We propose that this regime is complemented with an extension of the OSS to distant sellers and with simplified, not transaction based, revenue reporting. In conjunction with the original OSS model, this would limit VAT reporting to just one country and with the same level of detail as other retailers (i.e. not transaction based);
• **Option B** goes one step further by proposing an OSS responsibility also for tax audits with either the chosen Member State of reporting or a cross-border team of coordinated auditors. This would reduce the need for vendors to exchange the information with multiple countries’ tax authorities and would avoid conflicting viewpoints from such authorities leading to double taxation. This option in particular should have substantial value for SMEs that can now engage in cross-border trade based on guidelines referred above and being checked by local authorities as part of the standard compliance and audit checks. In principle, it removes a lever of control for the destination countries tax authorities, but in reality we suggest that this is mostly illusory as these tax authorities in any case have limited leverage over companies having often no physical or other market presence in their country beyond the "bits" send across the border by the internet;

• **Option C** goes yet one step further by proposing that country of origin rules apply to the definition of mixed supply, the definition of digital content services etc. This would further reduce the need for firms to assess the rules in other Member States. This would in particular benefit SMEs.

Our recommendation is that that the EU moves forward with joint implementation of all three options. Ultimately, it is a solution where individual e-commerce traders, whether of goods or digital services, only have formal relations with one national tax authority to whom it provides VAT payments and trading data when called for and which is responsible for audit controls. At the same time, the basis for this relationship is increasingly being made on the basis of uniform procedures across the EU for identifying traders, application of VAT in practice (joint supply, VAT on payment services etc.) where the EU Commission steps up its role as the guardian of the common market in line with the role outlined in recent VAT Communications.

**For the functioning of VAT payment and collection systems beyond 2015** we recommend intensified use of ICT to improve effective tax collection i.e. reduce the substantial VAT gap and reduce compliance costs. Earlier analysis has shown that far-ranging solutions such as the split payment system and the limited data warehouse system may eliminate the bulk of the yearly VAT gap of EUR 119 billion at EU level. Thus, it could provide a sizeable contribution to the consolidation of public finances urgently needed in many EU countries. At the same time, there is also evidence that full implementation cannot credibly be made operational across the board within this decade. However, e-commerce is already effectively operating exclusively with digital payment systems. In this context, we propose that e-commerce could prove a very good test case for a more general implementation of such models.

We then recommend that two steps are taken now:

First, operators and authorities need to put into place systems for e-commerce that are workable from 2015. We recommend a package with all three options A, B and C above in addition to much stronger efforts of uniform implementation of VAT rules across the EU, with the legal instruments this require. Second, start preparing a pilot project for e-commerce for intensified use of ICT system, building upon earlier analysis and recommendations such as the combined model with the split payment and the limited data warehouse system. This can then evolve into more general reforms later in the decade.
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Simplifying and Modernising VAT in the Digital Single Market for e-Commerce

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ANNEX I

Problems arising from VAT exemption of universal service providers

All private non-universal postal service providers in the EU are subject to VAT while universal service providers, irrespective of private and public ownership, will have VAT treatment that varies across activities and countries\(^\text{106}\). An activity by universal service providers can be regarded as VAT exempt or non-taxable in one country while taxable in another. The VAT treatment of universal service providers in the EU can be divided into four categories cf. Figure A1 and Table A1. In the first category, only reserved area (which is letter weighting less than 50g) is exempted from tax while the rest activities are taxable (for example Bulgaria and Romania). In the second category, exemptions are applied to the specific Universal Service Obligations (USO), which are different across countries (such as Austria, Belgium and others). In the third category, all activities or products are exempt from VAT (such as Luxemburg). In the fourth category, all activities (products) are treated as taxable (Sweden and Slovenia).

Figure A1: VAT treatment of universal service provider (USP)

![Figure A1](image)

**Note:** Reserved area refers to the letter weighting less than 50g. The USO scope differs between the countries.

**Source:** Own exposition based on VAT rule on postal sector of the council Directive.

Table A1: VAT treatment of Universal service provider in the Member State

<table>
<thead>
<tr>
<th>Category</th>
<th>VAT treatment of USP</th>
<th>Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>VAT exemption on reserved area (Letters weighing &lt;50g)</td>
<td>Bulgaria and Romania</td>
</tr>
<tr>
<td>2</td>
<td>VAT exemption on USO (note that the USO scope differs between the countries-the table below)</td>
<td>Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Netherlands, Portugal, Slovakia, Spain</td>
</tr>
<tr>
<td>3</td>
<td>VAT exemption on all products</td>
<td>Luxembourg, Malta, Poland, UK*</td>
</tr>
<tr>
<td>4</td>
<td>VAT on all products</td>
<td>Sweden and Slovenia</td>
</tr>
</tbody>
</table>

**Note:** * Until 31.1.2011. From 31 January 2011 VAT will apply to products Royal Mail is not obliged by licence to provide which are not price controlled (all individually negotiated services, parcel force services, unaddressed mail, mailroom services)

\(^{106}\) Article 132 (1)(a) of Directive 2006/112/EC
The VAT exemption rule on the scope of USO varies from country to country and activities to activities in the EU cf. Table A2. For example in Bulgaria and Romania, USO activities are not exempt in contrast to countries such as Germany, France and others, where there is VAT exemption on some activities of the USO. Specifically, bulk mail (letter), which is VAT exempt in countries like Austria, Belgium, France and others, however it is liable to VAT other countries such as in Germany, Netherlands and Finland.

Table A2: Summary of VAT Treatment of USO services in the EU

<table>
<thead>
<tr>
<th>Scope of VAT exempt USO services</th>
<th>Countries and their standard VAT rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>All products</td>
<td>Luxembourg (15%) Malta (18%)</td>
</tr>
<tr>
<td></td>
<td>Poland (23%)</td>
</tr>
<tr>
<td>Basic letter post, Basic parcel post, Bulk letters, Direct mail, Periodicals, Non-priority letters, Bulk parcels</td>
<td>Austria* (20%), Belgium (21%), Greece (23%), Hungary (25%)</td>
</tr>
<tr>
<td>Basic letter post, Basic parcel post, Bulk letters, Direct mail, Periodicals</td>
<td>Cyprus (15%)</td>
</tr>
<tr>
<td>Basic letter post, Basic parcel post, Bulk letters, Direct mail, Periodicals, Non-priority letters</td>
<td>France (19.3%), Portugal (23%), Latvia (22%)</td>
</tr>
<tr>
<td>Basic letter post, Basic parcel post, Bulk letters, Direct mail, Non-priority letters, Bulk parcels</td>
<td>Slovakia (20%)</td>
</tr>
<tr>
<td>Basic letter post, Basic parcel post, Bulk letters, Non-priority letters, Bulk parcels</td>
<td>Lithuania (21%)</td>
</tr>
<tr>
<td>Basic letter post, Basic parcel post, Bulk letters, Direct mail**, Non-priority letters</td>
<td>UK (20%)</td>
</tr>
<tr>
<td>Basic letter post, Basic parcel post, Bulk letters, Direct mail</td>
<td>Ireland (23% in 2012)</td>
</tr>
<tr>
<td>Basic letter post, Basic parcel post, Bulk letters, Non-priority letters</td>
<td>Denmark (25%)</td>
</tr>
<tr>
<td>Basic letter post, Basic parcel post, Non-priority letters</td>
<td>Estonia (20%), Finland (23%)</td>
</tr>
<tr>
<td>Basic letter post, Basic parcel post, Periodicals</td>
<td>Germany (19%)</td>
</tr>
<tr>
<td>Basic letter post, Basic parcel post, Bulk letters</td>
<td>Spain (18%)</td>
</tr>
<tr>
<td>Basic letter post, Basic parcel post</td>
<td>Czech Republic (20%), Italy (21%), Netherlands (19%)</td>
</tr>
</tbody>
</table>

Note: * AT: according to § 3 Z 6 PMG distribution centres are not considered as access points, so all postal items that are consigned at distribution centres will be outside of universal service according to § 6 PMG. This may create potential problems with the definition of services within the universal service area.**UK: Direct Mail is not a service ensured as universal service by law but the products used are part of the USO (bulk mail)

VAT in cross-border postal market

In the case of cross-border postal market in the EU, before 1 January, 2010 it had been considered as exempt service, cf. chapter 3. However, after 2010 the following three things have to be fulfilled simultaneously for cross-border mail to be VAT exempt:

- The specific postal service to be provided cross-border must be part of the universal service in the sending country;
- The sending operator must be acting in capacity as a universal service provider;
- The delivering operator must be acting in capacity as a universal service provider.

To illustrate this issue, consider that a service that is part of universal services in country A (and thus exempt there) would become taxable if it is provided across the border to a country where it is not within the universal service area. For example, bulk mail is part of the universal service obligation in Belgium but not in the Netherlands. According to the old rules, bulk mail sent from Netherlands to Belgium would be tax exempt. However, in the new regime, there is no exemption because bulk mail is not part of the universal service obligation in the Netherlands. On the other hand, bulk mail sent from Belgium to the Netherlands would continue to be tax exempt.

As we have discussed so far, postal sector treatment of VAT is different across countries as well as across USO services in Member State. This creates distortion in digital market in three possible ways.
### ANNEX II

#### Table A3: Thresholds for application of the special scheme for distance selling

<table>
<thead>
<tr>
<th>Member State</th>
<th>Threshold</th>
<th>Euro equivalent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>EUR 35,000</td>
<td></td>
</tr>
<tr>
<td>Bulgaria</td>
<td>BGN 70,000</td>
<td>35,791</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>CZK 1,140,000</td>
<td>46,750</td>
</tr>
<tr>
<td>Denmark</td>
<td>DKK 280,000</td>
<td>37,557</td>
</tr>
<tr>
<td>Germany</td>
<td>EUR 100,000</td>
<td></td>
</tr>
<tr>
<td>Estonia</td>
<td>EUR 35,151</td>
<td></td>
</tr>
<tr>
<td>Ireland</td>
<td>EUR 35,000</td>
<td></td>
</tr>
<tr>
<td>Greece</td>
<td>EUR 35,000</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>EUR 35,000</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>EUR 100,000</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>EUR 35,000</td>
<td></td>
</tr>
<tr>
<td>Cyprus</td>
<td>EUR 35,000</td>
<td></td>
</tr>
<tr>
<td>Latvia</td>
<td>LVL 24,000</td>
<td>34,052</td>
</tr>
<tr>
<td>Lithuania</td>
<td>LTL 125,000</td>
<td>36,203</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>EUR 100,000</td>
<td></td>
</tr>
<tr>
<td>Hungary</td>
<td>HUF 8,800,000</td>
<td>32,257</td>
</tr>
<tr>
<td>Malta</td>
<td>EUR 35,000</td>
<td></td>
</tr>
<tr>
<td>Netherlands</td>
<td>EUR 100,000</td>
<td></td>
</tr>
<tr>
<td>Austria</td>
<td>EUR 35,000</td>
<td></td>
</tr>
<tr>
<td>Poland</td>
<td>PLN 160,000</td>
<td>40,293</td>
</tr>
<tr>
<td>Portugal</td>
<td>EUR 35,000</td>
<td></td>
</tr>
<tr>
<td>Romania</td>
<td>RON 118,000</td>
<td>28,012</td>
</tr>
<tr>
<td>Slovenia</td>
<td>EUR 35,000</td>
<td></td>
</tr>
<tr>
<td>Slovakia</td>
<td>EUR 35,000</td>
<td></td>
</tr>
<tr>
<td>Finland</td>
<td>EUR 35,000</td>
<td></td>
</tr>
<tr>
<td>Sweden</td>
<td>SEK 320,000</td>
<td>36,232</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>GBP 70,000</td>
<td>81,843</td>
</tr>
</tbody>
</table>
Source: DG Taxud Data base

Table A4: VAT rates in selected EU countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Paper Books Current Rate</th>
<th>Current Standard VAT rate</th>
<th>Standard VAT with full VAT Reform</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>21</td>
<td>21</td>
<td>15.8</td>
</tr>
<tr>
<td>Germany</td>
<td>7</td>
<td>19</td>
<td>15.54</td>
</tr>
<tr>
<td>Greece</td>
<td>6.5</td>
<td>23</td>
<td>19</td>
</tr>
<tr>
<td>Spain</td>
<td>4</td>
<td>18</td>
<td>12.7</td>
</tr>
<tr>
<td>France</td>
<td>7</td>
<td>19.6</td>
<td>12.7</td>
</tr>
<tr>
<td>Italy</td>
<td>4</td>
<td>21</td>
<td>13.7</td>
</tr>
<tr>
<td>Hungary</td>
<td>5</td>
<td>27</td>
<td>23.1</td>
</tr>
<tr>
<td>Poland</td>
<td>23</td>
<td>23</td>
<td>14.45</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>0</td>
<td>20</td>
<td>14.88</td>
</tr>
</tbody>
</table>

DIRECTORATE-GENERAL FOR INTERNAL POLICIES

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ECONOMIC AND SCIENTIFIC POLICY

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