taxnotes® international

Volume 89, Number 5 ■ January 29, 2018

E-Commerce in the European Union: Can the EU VAT Keep Pace With the Changing Economy?

by Ronan McGivern, Jennifer Mace, and Dan Cassidy

Reprinted from *Tax Notes Int'l*, January 29, 2018, p. 449

E-Commerce in the European Union: Can the EU VAT Keep Pace with the Changing Economy?

by Ronan McGivern, Jennifer Mace, and Dan Cassidy

Ronan McGivern is a fellow of Chartered Accountants Ireland, an AITI chartered tax adviser, and a partner in the tax department of RBK in Dublin. Jennifer Mace and Dan Cassidy are CPAs and principals in the tax department of Clark Nuber PS and based in Seattle.

In this article, the authors discuss the EU's VAT and proposals to help it adapt to e-commerce and the ever-changing marketplace.

"Modernising the VAT system and adapting it to the challenges posed by the fight against fraud is key for the future of our single market."[1]

In an earlier article in this publication,[2] we provided an overview of key VAT principles and explained some unique features of VAT in the EU. In this article, we focus on the challenges that e-commerce poses for VAT. We will consider some inherent deficiencies in the existing EU VAT system, focusing on e-commerce, and look at the steps being taken by the EU to address these limitations in the current VAT legislation.

I. Challenges for VAT in the Modern World

A. Different VAT Rates for Goods vs. Services

The European Commission has described the EU VAT system as an "asset of the Single Market . . . removing obstacles that distorted competitions and prevented the free movement of goods."[3] However, the VAT system has not kept pace with global trends. The way goods and services are purchased and consumed has fundamentally changed. Similarly, the distinction between what constitutes "goods" and what constitutes "services" has become blurred, an issue we reviewed in Section II.B of our prior article.

The clearest example of this anomaly is how e-publications (such as e-books) and hard copy publications are treated differently. Within the EU, a supply of books is generally zero-rated (that is, no VAT is applied) and is regarded as a supply of goods. The classification also has implications for the place of supply, VAT registration, and other matters (again, refer to our prior article for more detail). An extract from the Irish Revenue Commissioners VAT practice manual very lucidly illustrates the conundrum posed by the treatment of e-publications. Notably, Irish Revenue simply sets out the VAT treatment required to comply with EU law:

> When printed matter is purchased and downloaded via the internet it is considered to be a service within the meaning of electronically supplied services. This will have implications for non-EU suppliers where the customer is a private consumer . . . . All digitised publications regardless of their VAT rate when printed (e.g. a book liable at zero rate) are treated as a supply of services

[1] European Commission, Communication From the Commission to the European Parliament, the Council and the European Economic and Social Committee, "On the Follow-Up to the Action Plan for VAT Towards a Single EU VAT Area — Time to Act" (Oct. 4, 2017), COM(2017) 566 final (2017 report).

[2] Ronan McGivern, Jennifer Mace, and Dan Cassidy, "E-Commerce in the European Union: Is the EU VAT Area Fit for Its Purpose in the 21st Century?" *Tax Notes Int'l*, Dec. 11, 2017, p. 1063.

[3] 2017 report, *supra* note 1.

rather than goods and are classified at the Standard Rate.[4]

Commercially this treatment is nonsensical. Why should the way a consumer chooses to consume a product dictate the VAT rate and therefore the cost? At a minimum, this creates an unfair market. If one means of consuming a product is tax-free while another is taxed, the tax system is effectively subsidizing one sector of the economy at the expense of another.

B. Transitional vs. Destination-Based VAT

In the 2017 report "On the Follow-Up to the Action Plan for VAT Towards a Single EU VAT Area — Time to Act" (the 2017 report), the European Commission notes that the current EU VAT legislation is based on "transitional arrangements," while recognizing that these arrangements have existed for 25 years.[5] We discussed some of these complex rules in detail in Section III of our previous article, which focuses on the place-of-supply rules. The system was meant to ease the transition to a fully destination-based system — it is partially based on the location of the supplier, rather than fully based on the location of the consumer.

The transitional legislation treats domestic supplies of goods and services and cross-border supplies of goods and services differently. There is also a distinction between supplies to private consumers and supplies to business customers. The transitional arrangements have created problematic anomalies in the e-commerce arena because they can result in a different place of deemed supply depending on whether goods or services, distinctions that are less meaningful in the e-commerce space, are being supplied.

VAT is a tax on consumption. Ultimately, the EU intends for suppliers to account for VAT on goods, supplies, and services at the applicable VAT rate in the consumer's jurisdiction (the destination-based VAT system referenced above). However, after 25 years we are still applying confusing transitional arrangements.

C. Fraud

Changes to EU VAT rules are necessary — not simply because of their impact on businesses — but also because of the significant cost to the EU economies stemming from fraud and noncompliance with VAT regulations. The EU estimates that its members lost €151 billion in VAT revenue in 2015, or 12.8 percent of the total VAT liability, because of fraud and other forms of leakage.[6] To put this in context, there is a protracted debate between the EU and the U.K. over the size of the U.K.'s "divorce payment" because of Brexit, with some commentators putting the bill in the realm of €65 billion. The lost VAT revenue for the EU member states in 2015 alone was more than double that penalty. When the actual lost VAT revenue is projected out over several years, the figure is truly staggering.

VAT fraud and noncompliance takes many forms. At one end of the spectrum, there are the sophisticated carousel fraud schemes often linked with organized crime or terrorism. At the other end, there is the difficulty associated with enforcing VAT compliance on non-EU companies that supply goods and services to EU consumers via online platforms. While the individual supplies might be relatively low in value, the volume can be significant.

There are many reasons for fraud and noncompliance. However, the inherent nature of the VAT treatment of cross-border supplies in the EU provides opportunities for fraudsters. While the EU is a single market, each EU member state has its own national revenue authority. This leads to fragmentation, a boon to would-be fraudsters. Tax authorities carry out revenue audits under their local rules. It is much more difficult for a revenue authority in one jurisdiction to audit the affairs of a taxpayer in another EU member state.

Unlike U.S. sales and use tax, VAT is applied throughout the supply chain. A business making taxable supplies can claim a refund of VAT incurred on goods and services purchased for its business provided it holds valid VAT invoices.

Of the total estimated €151 billion of VAT revenue lost annually to fraud, the European

[4] Irish Tax and Customs, "Tax and Duty Manual — VAT and Printed Matter" (May 2017).

[5] 2017 report, *supra* note 1.

[6] *Id*.

Commission estimates that €50 billion is lost because of cross-border fraud alone.[7]

D. Effect on Small and Medium-Size Entities

The EU is proud to be a market of 500 million consumers and the world's largest single market with transparent rules and regulations. This — in theory — allows small or medium-size enterprises established in one EU member state to access a huge market. These opportunities are amplified when one considers today's globalized business world, especially in the context of e-commerce.

Unfortunately, all is not as it seems. Many U.S. businesses will relate to the obstacles that the VAT rules create for cross-border trade. Suppliers may be obligated to register in multiple EU jurisdictions. Each EU member state has its own tax registration requirements. This means that every EU member state in which a business registers may have a different registration process requiring different information. VAT registration can take more than two months — per jurisdiction. This can be especially frustrating for a business that has already gone through the process and obtained a VAT number in another EU jurisdiction.

Once a business is registered for VAT in an EU member state, it must then manage the ongoing VAT compliance obligations and file multiple VAT returns, not all of which are standardized. It may surprise some readers to learn that filing obligations differ among EU jurisdictions, with different jurisdictions imposing monthly, bimonthly, or quarterly requirements. The European Commission has, in its December 5 VAT package, estimated that "companies that sell goods online pay around €8,000 in VAT compliance costs for every EU country into which they sell."[8] While managing these ongoing compliance obligations, businesses must also deal with multiple national revenue authorities.

The European Commission estimates that "businesses trading cross border bear an extra compliance cost of 11 percent in comparison to businesses trading only domestically."[9] The additional compliance costs may be a drop in the bucket for large businesses with a dedicated finance function that can manage this process. SMEs, however, may not have the in-house capability and may need to rely on external advisers to a greater degree. The cost of getting VAT wrong can be significant with different penalty and interest regimes in each jurisdiction. This can be quite daunting for SMEs.

Our last article discussed the four freedoms underpinning the EU single market, including the free movement of goods and services. For SMEs, including many start-ups operating on tight margins, an additional 11 percent compliance cost doesn't sound anything like "free." When concerns about the cost of complying with legislation arise, particularly concerns about duplication of costs, it is a clear indication that something is amiss and that the so-called single market must be fixed.

II. Developments

Changes in VAT rules historically have moved at a snail's pace. Over the last few years, however, we have begun to see real movement and acceptance of the need for change. On April 7, 2016, the EU published an action plan on VAT titled, "Towards a Single EU VAT Area — Time to Decide."[10] In the action plan, the European Commission specifically identifies and acknowledges the multitude of problems within the EU VAT system. The 2017 report is a follow-up to the action plan that introduces new legislative provisions and helps keep the initial momentum going.[11]

Below, we consider some of the specific developments and initiatives in the 2017 report.

A. Technological Inequity

The European Commission has acknowledged the inequity inherent in the different treatment of supplies of printed matter

[7] *Id.*

[8] *See* European Commission release on the VAT Digital Single Market Package (Dec. 5, 2017).

[9] 2017 report, *supra* note 1.

[10] European Commission, Communication From the Commission to the European Parliament, the Council and the European Economic and Social Committee, "Towards a Single EU VAT Area — Time to Decide" (Apr. 7, 2016), COM(2016) 148 final.

[11] *Supra* note 1.

and supplies of e-publications. It has introduced a proposal (under discussion by the EU Council) that would enable EU member states to apply the same VAT rates to e-publications as applies to printed versions. The commission calls this a "step forward in ensuring technological neutrality and removing tax obstacles to the development of the e-publications market."[12]

In making this statement, the EU clearly admits that the existing legislation creates a competitive distortion and can produce obstacles to the development of trade. We are now in 2018. Kindles and e-readers have been on the market since 2007 — more than 10 years (and the ability to download texts existed before those tools arrived on the market) — yet the EU VAT is only now addressing the technology they represent.

B. A Definitive Destination-Based VAT

After 25 years of "transitional" arrangements, the EU is, as announced in the action plan and reiterated in the 2017 report, finally taking steps toward a definitive VAT system "based on the principle of taxation in the Member State of destination."[13] The European Commission acknowledges that there should be no distinction between the VAT treatment of domestic supplies and cross-border supplies. This rule should help simplify the system for businesses.

The introduction of the new place-of-supply rules for supplies of e-services to consumers, effective January 1, 2015 (discussed at length in Section III.B.3 of our December article), represents a real step toward the implementation of a true, definitive destination-based VAT system. The European Commission has committed to adopting a directive this year that will introduce provisions aimed at implementing a new destination-based VAT system effective January 1, 2022.[14]

C. Extension of One-Stop Shopping

Part of the reason for the lengthy tenure of the transitional VAT arrangements and for the long delay in implementing a destination-based VAT system is that there have been numerous challenges associated with paying VAT in multiple jurisdictions. For a destination-based VAT system to function, a supplier must be able to account for VAT in all jurisdictions where it operates to one revenue authority. This creates multiple challenges, including legislative, technological, and political obstacles.

U.S. taxpayers doing business in the EU frequently complain about the inability to simply register in one member state and account for VAT on all supplies across the EU in that member state. The introduction of the mini one-stop shop (MOSS) for the supply of telecommunications, broadcasting, and electronic services to consumers is a first step toward a solution. The European Commission has concluded that rolling out the one-stop-shop mechanism for other cross-border supplies is the best way to achieve a destination-based VAT in a cost-effective way.

With a fully functional destination-based VAT system operating through the one-stop-shop mechanism, businesses will be able to account for VAT on all their supplies (both goods and services) across the EU in one jurisdiction. The next significant milestone is the rollout of the one-stop-shop mechanism to all distance sales (discussed generally in Section III.A.1 of our prior article), scheduled to take effect January 1, 2021.[15]

D. Reduced VAT Compliance Costs

The European Commission is studying the VAT registration processes in all member countries and looking at the information required on their VAT returns. We hope that this will lead to a more standardized VAT registration process, along with standardized VAT returns and filing dates.

Notably, the existing MOSS regime for e-services has already helped reduce compliance costs for businesses. The European Commission estimates that "VAT compliance costs for businesses have decreased by €500 million, or about €41,000 per company."[16] The proposed one-stop-shop solution should help extend this benefit and further reduce compliance costs. This is a real

[12] *Supra* note 1.

[13] *Id*.

[14] *Supra* note 1.

[15] European Commission release, *supra* note 8.

[16] *Id*.

benefit for businesses operating in multiple EU territories. Given the disproportionate effect of compliance costs on SMEs, we hope this plan will remove one obstacle preventing small businesses from doing business across EU borders.

The changes should also benefit U.S. businesses and reduce the complexity of complying with the EU VAT. They will be able to register in one jurisdiction (Ireland is a great entry point for U.S. businesses seeking to do business across the EU) and administer their VAT obligations for supplies across the EU from that one jurisdiction.

E. Closing the VAT Gap and Fighting Fraud

As noted in Section I.C of this article, cross-border fraud is estimated to account for €50 billion of lost VAT revenue each year in the EU. Fraud reduction would not only benefit the member states, but also would benefit the majority of taxpayers — after all, the majority are compliant, even if the noncompliant minority require extra attention. Ultimately, VAT fraud puts compliant businesses at a competitive disadvantage because a competitor that is not charging VAT can effectively undercut a compliant company's prices.

The European Commission is focused on tackling fraud and closing the VAT gap. The general goal is to identify fraudulent networks more quickly. An EU-wide solution is required. Several initiatives have been proposed including a call for greater coordination among national revenue authorities, improved information sharing systems, and risk profiling at a pan-European level.

The commission also has proposed the temporary application of a generalized reverse charge mechanism for supplies of goods and services above specified levels. This means that VAT is suspended along the supply chain and ultimately is charged only to the end user. This mechanism is specifically intended to target and reduce carousel fraud.[17]

The European Commission also has proposed the notion of "certified taxable persons" for VAT purposes. This is a business that has received an attestation from the appropriate member jurisdiction stating that it is a reliable taxpayer. These taxpayers would be entitled to special tax simplifications, including cash-flow benefits.

Another proposal aimed at improving VAT collections in the e-commerce sector calls for cooperation between tax administrations (public) and logistics companies, internet platforms, and payment service providers (private). In the December 5 VAT package, EU member states agreed to a provision that holds large online marketplaces responsible for ensuring VAT is collected on sales of goods by non-EU companies to EU consumers. This includes goods stored by non-EU companies in fulfillment centers based in the EU. This reform is set to be introduced in 2021. The European Commission estimates that €5 billion of VAT is lost by EU member states annually because of noncompliance with VAT on cross-border online sales (distance sales).[18]

III. Conclusion

The EU and the single market are among the great achievements of the 20th century. Still, the EU is not perfect. As a union of 28 — soon to be 27 — independent member states, it is a leviathan and can be very slow to change course. Unanimity among member states is required to make changes to the tax rules. However, there is no doubt that the EU VAT system has not been fit for its purpose for a long time. It is overly complex and fragmented, provides opportunities for fraud, and imposes burdens on the free movement of goods and services. A change from the transitional VAT arrangements to a definitive destination-based VAT is long overdue.

The changes introduced to date and those currently proposed represent real steps toward enhancing the single-market concept. Movement toward a one-stop shop makes sense from a business perspective and should provide further opportunities for businesses that want to do business in the EU but are concerned about the complexity of VAT regulations.

The move toward one-stop shopping and a destination-based VAT system also will require closer working relationships among the members'

[17] 2017 report, *supra* note 1.

[18] European Commission release, *supra* note 8.

national revenue authorities. This must include significantly increased information sharing and, ultimately, cross-border revenue interventions. If the revenue authority of one EU member state is collecting VAT for other EU member states, those other EU member states are relying on the collecting jurisdiction to protect their tax bases. This presents a political challenge. Ultimately, we believe that increased cooperation among tax authorities and EU oversight will be required. However, awareness and acknowledgment of the problems is the first step toward creating an EU VAT area that truly is fit for its purpose in the 21st century. ■