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European VAT on Digital Sales

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Abstract

This paper critically analyses the effort made by the European Community to preserve the functionality of the European system of VAT within the digital trade environment. On 7th May 2002 European, Council adopted a Directive and a Regulation to amend the existing VAT legislation, an action that EU believes would remove the serious competitive disadvantage EU companies suffers against its non-EU suppliers of digital services. By adoption of this Directive the taxation jurisdiction shifts from the location of sale to the location of the consumption of goods, thereby removing the EU' disadvantage and taxing all digitally delivered products at uniform rate. The VAT Directive made the EU the first significant tax jurisdiction in the world to develop and implement a simplified framework for consumption taxes on e-commerce. However, this unilateral approach of EU has come under severe criticism. The key to the success of this Directive is online identification of consumers. As of now technology will not allow the online seller to verify the location of a consumer or whether the consumer is VAT registered. The Directive assumes that this technology will become available. Against this back drop the paper re-emphasis the need to have increased international cooperation for administering consumption taxes.

Keywords: E-Commerce, Direct E-Commerce, Digital products, VAT, VAT on E-Commerce, Tax on Digitally Delivered Goods, VAT on Digital products, European Council Directive: VAT on Digital Sales

1. Introduction

On 7th May 2002,the European Commission welcomed the Council's adoption of a Directive and a Regulation to amend the existing VAT legislation. The proposal, which comes into effect from 1st July 2003, will require non-EU resident vendors to apply VAT when selling 'digital goods' in the EU. The new rules are based on Commissions proposals of 7th June 2000 (see IP/00/583 and MEMO/00/31) and are supposed to counter an 'unfair advantage' enjoyed by non-EU traders.

An American company selling its software to Europeans through its website, encourages customers to download the software directly by saying that there is '*no value added tax, shipping or export charge*'. This one-sentence scenario gives a condensed summary of the problem constituting the core of this paper. This paper will also address the background to the Directive, the Directive itself, and its implications for future, whether it preserves the functionality of the European system of value added taxation within the digital trade environment.

2. Development of the Issue

E-commerce, by utilising the Internet for commercial purposes takes advantage of all the benefits of this network of interconnected computers. The global nature of competitive electronic market place means that it is not constrained by geographic or economic boundaries and those who are best positioned are able exploit it to their benefit. Hence, such a radical transformation in the conditions of commercial activity required legislators to adjust all branches of law governing trade, which is effective to the new circumstances.

The provisions of a clear and certain regulatory environment is accepted by both business and governments as an essential prerequisite to creating the climate of confidence in which business will invest and trade. Whilst unilateral attempts can be stifling to creative process that drives economic activity, regulatory indecision can be similarly disruptive.

International cross-broader taxation principles are not entirely functional within this new 'virtual' world. Following from the unprecedented opportunities brought about by e-commerce for improving the efficiency and competitiveness of the economy, governments generally intend to enhance the flourishing thereof even if extending the existing regulatory framework to online trade. This is especially true with respect to taxes on transactions, such as value added tax. VAT concepts are mainly designed to operate based on the geographic location of the parties or the transactions. These tax points disappear when business activity is pursued through the Internet. Governments therefore are facing the task of defining new tax points capable of catching online transactions if they wish to preserve their revenues. The impact of decisions taken in relation to tax system will play a role in determining whether e-commerce achieve its potential contribution. It is essential that taxation is not a barrier to its growth but rather fosters the climate within which this occurs whilst protecting the interest of all stakeholders.

The European standpoint expressed in the 'Green Paper' on Electronic Commerce presents the general structure of policy instruments, including tax policy, necessary to encourage the development of e-commerce. The VAT has a special task in the European integration process. Apart from contributing to the resources of the Community, VAT as a tax on transactions is also responsible for ensuring the free flow of trade within the Community, which was the primary ambition of the integration process. The result of the European VAT harmonisation therefore can be a good example of how to tackle the inter-jurisdictional problems of this tax in order to avoid any barriers to international trade. Community efforts to adjust the VAT system to the digital environment might also serve as a model for global co-operation on this field. However, European Community should also consider the international context of the legislation concerning e-commerce.

Cross-border electronic transactions being the subject of several jurisdictions requires the laws of these jurisdictions are coordinated internationally. This makes international co-operation indispensable and assigns a significant role to international community in policy harmonisation. International agreement in the specific field of taxation is even more crucial. If governments wish to avoid double- or non-taxation, they must find a way to approximate their views. Consequently, success of the European proposals largely depends on their international acceptability.

3. Background to the Proposal

In the Lisbon European Council, meeting on March 2000, the 15 Member States agreed that concrete measures were to be taken to allow e-commerce to reach its full potential in the EU. The Council decided that this could only be achieved through the furtherance of rules that would make the regulation of e-commerce inside the EU as predictable as possible while at the same time inspire business and consumer confidence. Informally the Council approved the efforts that were already being made since 1997 to draft a proposal for a Council Directive to amend the Sixth Directive in the light of the new fiscal challenges.

In 1997 European Commission made one of the first official statements on the future of the EU's, VAT system when the Commission started to examine the tax implications of e-commerce. This approach was inspired by the fact that the Internet as a novel way to trade internationally was posing questions on whether the existing fiscal principles and mechanisms would be able to collect the potential tax revenue created by e-commerce. During 1997 the Commission launched a series of informal meetings with representatives of the 15 national tax administrations who examined the ways in which the growth of e-commerce was likely to effect the EU's VAT structure, and attempted to short-list the problems that could be encountered and the practical ways to overcome them.

By April of the following year, the Directorate General for VAT and Customs (XXI) was able to produce an *Interim Report*. Following an review of the ways in which e-commerce was marked to influence the ways in which people and businesses buy and sell things, and therefore how they consume goods and services for purposes of VAT, the report concluded that the existing system of indirect taxation was the best way to approach the fiscal challenges of e-commerce. However, the Interim Report also pointed out that the administration would need to be mindful of the likely impact of changes in the pattern and in the volume of transactions. At this time therefore, the Commission committed itself of not introducing any new mechanisms of taxation or amending the legal base of the Sixth Directive and recommended that the existing system would be sufficient to ensure collection of taxes.

The Interim Report also outlined some of the immediate hurdles. This was in particular applied to physical goods that are purchased by private consumers over the Internet but are then delivered by traditional means. For VAT purposes, these are treated in the same way as any other form of distance sales, either in the Member State of the seller or the buyer (dependent largely on the volume of such trade carried out by the other seller). There are well established channels for taxing these transactions- goods purchased from third countries are taxed at import, exported goods are zero-rated, and intra -community sales of goods are taxed under a special regime for distance sales. While the report said that no changes were necessary it however called for a simplification of the rules on the custom clearance of small volume imports and at the same time it did not exclude that as more and more people would be ordering goods from Internet stores some fine-tuning of the EU distance selling rules would become necessary. Meanwhile, the Commission had anticipated that a simplification of the customs clearance procedures could be included in the framework of the next VAT strategy drawn up by the EU.

The Interim Report further recommended that a revision of VAT rules was urgently necessary to protect the tax base for direct e-commerce transactions. The possibility that products could be delivered electronically was something unheard of when the Sixth Directive was first put into place. The Directorate General warned as early in 1998 that there is possibility of revenue loss and could give rise to serious long-term problems for tax administrations. It was decided therefore that amendments to the Sixth Directive were to be made as quickly as possible to prepare the European VAT system to the inevitable explosion of e-commerce, and particularly the possibility of new products being delivered digitally. It was proposed that the VAT legislative base be amended to take into account new principles and review the models of compliance, control, and enforcement. It also recognised that a level of concerted effort based on international collaboration was being necessary in streamlining principles, avoiding double taxation or unintentional non-taxation.

Hence, to achieve international consensus European community worked along with the OECD to provide a wide international forum bringing around the same table the major countries that both adopted a system of indirect taxation compatible with that of the EU and which are major trading partners of EU. To this end, the Commission adopted a set of guidelines published in June 1998, drafted on the principles which regulate VAT in the EU, these guidelines gave due recognition to the need for international accord. The starting point for the achievement of this harmonisation, the guidelines suggested, was an international recognition of neutrality as the most important principle in any fiscal treatment of e-commerce.

This principle of neutrality was also included among the five principles contained in the Taxation Framework Conditions approved by the participating Ministers in the Ottawa conference of OECD, and during the ensuing work by the various working parties of the Committee on Fiscal Affairs and particularly the talks with representatives of business, it emerged as the most important principle. In its guidelines, the Commission described the principle of neutrality as the basic condition that would link the trading between the EU and the rest of the world, and ensure that all electronic supplies for consumption in the Community would be subject to EU VAT while supplies to other jurisdictions would be not. This approach which in effect tried to make non-EU based suppliers charge VAT on the products delivered to the customers within the EU would eventually lie at the basis of the proposal for the Directive amending the Sixth Directive in an attempt to level the competitive advantage enjoyed by non-EU vendors over EU vendors.

The Commission’s communication was considered by ECOFIN council at its meeting on 6th July 1998 which welcomed them as the basis of a consistent Community input to the forthcoming OECD Ottawa conference and the political foundation on which changes to the VAT system made necessary by e-commerce should be made. The ECOFIN summarised this political framework in three points:

1. The existing system of VAT should be used for the indirect taxation of e-commerce and new forms of taxes should be excluded. This requirement follows from the principles of neutrality and simplicity. Neutrality in this context means that the method of commerce used to effect transactions should not influence the consequences of taxation. The principle of simplicity aims at keeping the compliance burden of the tax system to a minimum.

2. Electronic deliveries warranted a revision of the interpretation of the distinction between goods and services which is fundamental in the workings of VAT, and recommended that products that are delivered through digital means should not be considered as goods but services through a specific provision to that effect in the Sixth Directive. Due to the lack of tangibility in case of electronic transmissions,

this classification is the only way to catch these transactions for VAT purposes. By clearing up the uncertainty surrounding the interpretation of digital deliveries at the moment, this guideline also serves the purposes of legal certainty, which is essential for reducing the risks of unforeseen tax liabilities.

3. That the jurisdiction of the EU to charge VAT on indirect e-commerce should be limited only to those products consumed within the territory of the Union and therefore making necessary a revision of the interpretation of the principle of consumption.

The ECOFIN also recommended that effective ways for the control and enforcement of e-commerce should be explored, highlighted the need to adopt a legislative framework through which electronic invoicing would be allowed throughout the EU without the need for supplier to issue also paper invoices and simplifying as much as possible the rules with which non-EU operators have to comply, most notably the requirements of registration for VAT purposes. Finally, the ECOFIN also considered the importance of automating all the fiscal obligations of operators by enabling them to discharge them through electronic VAT declaration and accounting. The council further said that once a mechanism enabling the returns to be filed and declarations to be made electronically was in place, there should be no reason why this should be limited only to e-commerce businesses and thus simplifying the entire VAT system by modernising and computerising it.

Ottawa conference of OECD in October 1998, Taxation Framework Conditions confirmed the Commission's approach, which generally repeated the principles, which had been advocated in the EU in its first initiatives on the subject a year earlier. The Commission further recognised that answers to the questions posed by the fiscal treatment of e-commerce should be pursued in close association with the business community, who together with the national tax administrations, would be directly affected by any potential changes to the Sixth Directive. For this reason in January 1999, the Commission organised a Round Table conference in Brussels on the options available to the EU VAT system and e-commerce. The meeting provided the Commission with the ideal opportunity not only to explain to the business sector its initiatives on the issue but also to encourage comments from the participants. This initiated a process of dialogue and led to the creation of an informal contact group between representatives of the Commission and of European business, which would continue meeting regularly to assess together any developments. The willingness with which businesses participated in meetings and discussions that characterised the consultation process can easily is explained through their concern to protect their commercial interests, above all, by ensuring that any new rules that would be introduced by the EU would be clear enough to ease compliance and above all guarantee certainty.

The Commission's Taxation and customs Union Directorate General issued a working Paper in June of 1999, this was a significant step forward at arriving to the level of certainty sought by the business community by proposing a set of options how the principles developed since then should be implemented through legislative amendments within the framework of the EU's VAT system. This duality followed from the fact that even though Europe wishes to take advantage of the great economic opportunity brought about by e-commerce; it also has an interest in protecting the revenues and competitiveness of its Member States. The *paper* outlined an approach that would be taken up by the Commission as one of the major concerns that should be addressed by legislative reform it also argued that since international trade was fast being dominated by the delivery of services in intangible form, the reverse charge mechanism was not adequate to comprehensively take into account the wide array of services that with constant technological developments were capable of electronic delivery.

The efficiency of any tax system largely depends on the voluntary compliance of the taxpayers. One of the core objectives of the VAT system therefore was to *minimization of the compliance burden*. Further to develop such administrative rules it should take account of the diversified, decentralized and evolving nature of the electronic market. For the sake of such requirements, the Commission proposed to facilitate electronic invoicing and the discharge of fiscal obligations by means of electronic VAT declarations and accounting. When voluntary compliance fails, tax systems should be ready to enforce fiscal obligations. As it will be seen below, *enforceability* is the *Achilles* heel of the prospective VAT system. Enforcement causes problems owing to the difficulties in identifying suppliers and customers in general within the digital world. However, the problem is more acute with respect to foreign suppliers. On what grounds and by which means can the European system oblige third country enterprises to comply with Community rules? The proposal of the Commission tried to find the answers to these questions.

4. Proposal For A Council Directive Amending The Sixth Directive

The EU Commission proposed amendments to the Sixth VAT Directive addresses a very narrow field of e-commerce, What is known as *direct e-commerce*, it focuses on the issue of cross-border supply of digitised products, with special regard to those destined to final consumers in the Community. The Proposal of 7th June 2000 was the first attempt to give a black-on-white solution to the problems, which were examined since 1997. It also put doubt on previous statements of Commission that there would be no need to effect any radical changes to the European VAT system and the e-commerce could be taxed using the same VAT platform, save some minor amendments such as the proposal itself. The explanatory memorandum spoke in brief how e-commerce is posed to change the way in which people buy and sell things, in other words the world of trade. The Commission predicted that at some point '*a full scale review of the exiting VAT*' would be necessary. June 7th Proposal failed to capture enough support and as result of which Commission placed the 7th May 2002 proposal. In the following section, I will discuss the June 7th Proposal. The basic objective that was laid down in the June Proposal also remained the same in May 2002 proposal. Hence the following discussion will provide a comprehensive outline along with some criticisms, specific issue based criticism will be provided along with May 2002 proposal.

4.1 June 7th 2000 Proposal

On June 7, 2000, the European Commission presented a proposal for a Directive to modify the rules for applying VAT to certain services supplied by electronic means as well as subscription-based and pay-per-view radio and television broadcasting. The Commission proposed to change the EU VAT regime for e-commerce operators by proposing amendments to Sec. 9, 12, 24, 28g, and 28h of the Sixth Directive.

> '*The Commission's intention is that the proposal should give e-commerce operators a clear framework in which to charge, collect and remit VAT on electronic deliveries*'.

The direction taken by the proposal is to:

- Clarify the provisions regulation that VAT chargeability;
- Simplify the procedures for the collection and remittance of VAT; and
- Remove the competitive advantage enjoyed by non-EU e-commerce operators.

Under current rules, goods imported into the EU are subject to import VAT, which is collected when the goods enter the EU. Non-EU sellers of goods are not required to register for or collect VAT. The lack of an obligation to register did not hinder the collection of the tax due because the VAT was collected at import and paid directly by the private customer. The importation of goods requires the same to be physically transported from outside the EU to a Member State where they would have to go through post or customs. Such shipments can presently be easily checked to determine whether the VAT has been paid or not. In the case when the VAT is still due, authorities would not release the goods until the buyer comes forward to settle the tax outstanding.

Whether a transaction should be subject to VAT or not, or at what rate such transaction should be charged is determined by processing a set of information. The determination of whether a transaction is subject to VAT, and according to what jurisdiction and rate should be easy enough to allow business themselves, although not without resource to tax professionals, to do it. For a person to be able to decide on the VAT chargeability of a transaction he must be aware of:

- The tax status of the customer;
- Under which jurisdiction would that transaction fall; and
- Which VAT rate should apply?

On the other hand for VAT purposes a supplier should know the tax status of his customer, and therefore whether he is either registered for VAT or otherwise a private consumer. Under the general VAT rules the supply of goods or services to a VAT registered business by a supplier that is established in the same Member State should be charged tax according to the prescribed rates while no tax would be charged by the supplier if the customer is a business registered for VAT in another Member State. In that case, the customer would be able to account for tax through the reverse charge mechanism. The above is already the case for the application of VAT to non-electronic transactions where the verification of the VAT registration number of a customer normally occurs through information made available by the national VAT authorities of the country of the supplier.

In the case of e-commerce, where the transaction would occur instantly, the supplier would need to be able to make the verification in real time and for this reason the proposal recommended that a structure should be put in place, augmented by the necessary tools and technical measures, to provide EU registered VAT numbers on-line. Clearly, the inability of the VIES system to provide online, real time verification prevents the suppliers from fully exploiting the comfort and speed offered by electronic trade and therefore potentially hampers the pursuance of such activity. Simultaneously with confirming the tax status of the customer, his location should also be verified. With regard to business purchasers, if the verification process through the VIES system is successful; the location of the business can be inferred from the registration number. In case of final consumers, there is no such supplementary system. With traditional circumstances, the consumer either paid on the spot or was required to let the supplier know of his address for purposes of delivery and payment. When ordering online, consumers use electronic mail for communicating with the seller, but e-mail addresses tell little about the real, physical residence of its user. The most evident means of finding out their location is to ask the customers to self-declare this information. However, unless underlining this practice with reliable verification buyers might feel tempted by the anonymity of online trade to disclose false facts. Despite the diverse efforts to solve this problem, there is still no reliable and feasible means of identifying and locating consumers in lack of voluntary compliance. For the time being suppliers might verify disclosed data by using the credit card information requested from the purchaser previous to the conclusion of the contract. They might also rely on the currency of payment in determining the taxing jurisdiction. Evidently, neither of these examples is a dyed-in-the-wool solution. Moreover the Commission also hoped it could rely on the modernisation of the VAT Information Exchange System (VIES).

The proposal had been subject of severe criticism by non-Europeans who would have to collect VAT on sales to customers in the EU and remit the tax to a VAT authority in the Member State of registration. The majority of critics fare from the US. Ken Wasch, president of the American Software and Information Industry Association, considered a notable lobby in the US Congress, was reported to have said that:

> '*US vendors should not be tax collectors for European governments. It is also doubtful, under public international law, whether the EU has any authority to impose such a legal obligation on US entities'*.

It also appears that on-line taxes for downloaded items would be higher than the taxes, which were being applied to the same products when these are delivered through traditional ways.

During the first week of July 2000, an American delegation led by Under-Secretary of Commerce Robert LaRussa was in Brussels for a series of meetings with Commission officials on how taxation and data protection were being effected by e-commerce. Speaking after one of the meetings LaRussa said:

> '*we need to set up some kind of process where the US and the EU with our business communities can address these issues. There are peculiar US-EU issues, and you really do need an early warning system or you are going to address them too late*'.

The European Commissioner for Taxation, Frits Bolkestein acknowledged that although VAT revenue losses because of business-to-consumers transactions were still small, but they were bound to grow and the sooner amendments were in place the better. Bolkestein described the present situation and the need for change thus:

> *'Today European producers of digital products, such as computer games and software, are at a competitive disadvantage compared with non-European producers because they have to apply VAT to their products within Europe. US competitors, by contrast, can export to Europe free of VAT. Similarly, European exporters to the US are now obliged to pay European VAT, whereas US producers are not faced with the same obligation. I propose to put European producers of digital products on an equal footing with US and Japanese competitors by applying VAT to digital imports into the EU and exempting digital exports from the EU. This would create a global level playing field for European and non-European companies'.*

The proposal sought to achieve this 'global level playing-field', where, however the US businesses would be unwilling to play.

But for Hardesty one of the critics to the proposal, the EU disregarded one of the fundamental conclusions of the OECD conference. The participating Ministers at the conference had agreed that for solutions on the indirect taxation of e-commerce to be truly effective these must be the result of an international consensus. He felt that Commission went foul of this agreement and pursued its own individual solutions without waiting for what might be internationally acceptable avenues of the indirect taxation of e-commerce.

The most controversial point that had been criticised in the proposal was the suggested introduction of a new single-place registration for VAT. This would have enabled the companies to apply for a VAT registration under one of the 15 national tax authorities and be able to trade with customers in the entire Community. Since the registration would have the effect of creating a place of establishment in the country of registration, all transaction of that company would be taxed according to the rates applicable in that tax jurisdiction. It is understandable how companies might prefer seeking registration in countries such as Luxembourg, which apply a 15 percent VAT rate instead of in countries with a higher rate, of up to 25 percent such as Sweden and Denmark. It is also understandable why countries such as Sweden and Denmark raised opposition to the amendments as they predicted a plummeting of their VAT revenues from tech-companies. Not only would VAT revenues decrease but the amendments would create an unfavourable situation also for the traditional brick-and-mortar as these businesses would be selling their products at a price which could be at least 10 percent more expensive than on-line retailers simply because the latter have a VAT registration in another Member State with lower VAT rates. On these grounds, Snel had criticised the proposal as running counter to the principles of neutrality and discrimination, which had earlier been identified by the ECOFIN council, and later also by the OECD, as two of the pillars on which any future taxation of e-commerce should be constructed. Snel further argued that the success of ideas such as a single point registration would depend on the willingness of operators to comply with such regulations. The only way to bring back an equilibrium between traditional retailers in high VAT Member States and the on-line competitors would be to apply the same lower VAT rates that apply for those type of services delivered by electronic means to services of the same class delivered off-line by the brick-and-mortar stores in the country with high VAT rates. However, such a task would be monumental and would be defying the Commission's philosophy that e-commerce should be taxed using the existing VAT platform. This is perhaps one of the first instances which confirm the Commission's concern that sooner or later the indirect taxation of e-commerce would call for a wider revision of the existing VAT system.

In late November 2000 meeting the ECOFIN council recommended to the Commission to rework the proposals and present an amended version. Shortly after the ECOFIN meeting, on the 28th November 2000 a detailed report on the proposal drawn up by the European Parliament's Committee on Economic and Monetary Affairs chaired by Jose` Manuel Garcia-Margalloy Marfil was tabled to Parliament. On The 14th December 2001, the Parliament voted to endorse the report as its official opinion suggesting a series of amendments to the Commission's proposal. In practice, this had the effect that the proposal was blocked and although not formally withdrawn, shelved for the moment.

The parliament stipulated that in order to ensure a fair sharing of VAT revenues resulting from transactions between non-EU suppliers registered in one Member State and non-taxable persons in another Member State, a system of refunds between Member States should be introduced. The Parliament further recommended that a structure should be created to provide for permanent monitoring by the Commission of the state of play as regards the implementation of the proposal in the Member States to ensure no distortion of the market. The original Commission proposal foresees that non-EU suppliers with annual sales above EUR 100,000 operating in the EU will have to register in at least one Member State, which would then be the tax jurisdiction responsible for applying the tax. The Parliament felt that to counter the risk, already mentioned above, of companies choosing to register in a low tax country such as Luxembourg, the Commission should draft another proposal to address the question of VAT revenue distribution among Member States. Moreover, the parliament proposed the threshold for registration be lowered from EUR 100,000 to EUR 40,000.

In the explanatory statement to the report the Committee on Economic and Monetary Affairs also spoke about the future convergence between Internet and mobile phone technology. The Committee outlined its position clearly concerning this and dismissed any problems because of a fundamental distinction, which was illustrated by means of an example. The report said that where a customer being able to download information through a mobile phone, the charge for connection and airtime would fall under the heading of telecommunications whilst the charge for the information would fall under the heading of e-commerce.

The Parliament's opinion broadly supported the Commission proposal in spite of some shortcomings. The report suggested that these shortcomings mainly result from uncertainties on future developments and advised that these should be overcome in time before entry into force of the proposed Directive.

> 'The creation of a level playing field in electronic services is a matter of urgency, but it is essential that a system of distribution of tax revenues be put in place to compensate the advantage of those Member States with the lowest VAT rates'.

Moreover, Parliament defended the proposal against criticism that it might be pre-empting the work that was still being undertaken by the OECD. The Committee mentioned how the main opposition to the proposal came from across the Atlantic with the intention of preserving the competitive advantage that American companies currently enjoy. This advantage was further strengthened by the US Congress's approval to extend the moratorium on the taxation of electronic services at least until 2003.

While drafting, its report the Committee sought the assistance of the Parliament's Committee on Industry, External Trade, Research, and Energy chaired by Carlos Westendorp y Cabeza and the Committee on Legal Affairs and the Internal Market chaired by Ana Palacio Vallelersundi. In its opinion the Committee on Legal Affairs and the Internal Market recommended that Parliament should request the Commission to withdraw its proposal for a directive until such time as:

> (i) a thorough review has been carried out on the VAT charged on goods and services supplied by non-electronic means;
>
> (ii) the ongoing discussions in the OECD and other international forum have been brought to a conclusion; and
>
> (iii) a complete package of measures can be proposed.

Finally, during the 5th June 2001 meeting of the ECOFIN council the British Finance Minister made known that his country would not support the proposal despite the fact that the other 14 Member States expressed their willingness for plans to implement the proposal to proceed. However UK' s blocking of the proposal led to the formulation of May 2002 proposal.

4.2 Verification of VAT Numbers for Electronic Supplies

The proposal of June 2000 also brought attention to the fact that the present regulation of the confirmation of the validity of VAT registration number of a person by the Member

State needed to be changed because this would not allow national VAT authorities to give confirmation of the validity of a customer's VAT identification number to a person supplying services by electronic mean. The procedure for the verification of VAT numbers is controlled through Sec. 6 of Regulation (EEC) No 218/92, which however limits the confirmation only to 'persons involved in the intra-Community supplies of goods or of services'. The proposal stressed that the confirmation of validity of VAT identification numbers by electronic means was one of the ways through which trade could be facilitated and therefore described its plans to amend the legal base to make such thing possible.

On June 14, 2002, the Commission introduced the on-line validation service. The on-line service, which any member of the public can now access free of charge, allows checking of the databases of VAT registration numbers which each Member State maintains as part of the VIES. The database of VAT identification numbers is only one aspect of the VIES. Members of the public logging on to the site will not be able to see any of the other VIES information which is used by Member States' taxation authorities for VAT control purposes and which should, in the interests of taxpayer confidentiality, remain reserved for the use of taxation authorities only.

Under the current VAT system, all intra-EU supplies between traders subject to VAT are exempted from VAT in the country of sale, the tax being declared at destination by the receiving trader. Normally the customer provides his VAT identification number to the supplier when he orders the goods. But it is the responsibility of the supplier to confirm that his customer is indeed VAT registered in another Member State before he sends the goods free of VAT. Otherwise, the supplier may be obliged to pay the VAT himself. Up to now, a supplier wishing to confirm the validity of the VAT identification number provided by its customer generally had to contact its own tax administration which would check the VIES and confirm that the number quoted was valid. By cutting out the intermediary, this new service speeds up this verification procedure, thus saving time and money for both businesses and tax administrations. The overall aim is to facilitate legitimate commercial transactions within the Internal Market while improving controls against fraud.

4.3 May 2002 Proposal (Council Directive 2002/38/EC)

On May 7th 2002, the European Council adopted the Directive 2002/38/EC and Regulation No. 792/2002. The new directive will take into effect on July 1st 2003, and shall remain in effect for three years, after which time it may be extended or revised. By the adoption of this directive digital service providers located outside of the EU would be required to register with European tax authorities by July 2003 and have to collect VAT on sales of digitally delivered products. While the rules do, indeed, place new burdens on some foreign firms, European Commissioner for Taxation Frits Bolkestein believes that ultimately, everyone's interest will be served by the legislation:

> '*I welcome the decision of the council to adopt these rules on applying VAT to digital products. They will remove the serious competitive handicap which EU firms currently face in comparison with non-EU suppliers of digital services, both*

> *when exporting to world markets and when selling to European consumers*,' said Bolkenstein.

The Directive applied to electronically delivered services as well as radio and television broadcasting services. The first category included digital products that are distributed over the Internet such as software. The EU treats all products that are distributed electronically as services. An annex to the proposed legislation sets out an illustrative list of the type of services that are targeted by the new framework.

- Web site supply, web hosting, distance maintenance of programs and equipment;
- Supply of software and updating thereof;
- Supply of images, text, information and making databases available;
- Supply of music, films and games, including games of chance and gambling games, and of political, cultural, artistic, sporting, scientific and entertainment broadcasts and events;
- Supply of distant teaching;

The Proposal contained two separate sets of provisions. The redefinition of the place-of-supply rules for electronic deliveries and the amendment of connected administrative provisions necessary for the implementation of the redefined rules along with that a set of provisions under a special scheme to facilitate the compliance with fiscal obligations by operators providing electronically supplied services, who were neither established nor required to be identified for tax purposes within the Community form the heart of the Proposal. The other key point of the document was the set of provisions facilitating the discharge of VAT obligations by electronic means.

The Proposal sets forth two distinct places of supply for digital deliveries in accordance with the varying tax status and location of the recipient. The first place-of-supply rule determined the place of transactions to final consumers within the Community. It deems the location of the supplier's business or fixed establishment as the place-of-supply. This resulted in the practical extension of the general place-of-supply rule of the Sixth Directive to business-to-consumer digital transmissions.

Sub-paragraph 1(b) of the Directive proposes that:

(1) In Article 9(2), the following point (f) is added:

> '(f)…the place where services referred to in the last indent of subparagraph (e) are supplied; when performed for non-taxable persons who are established, have their permanent address or usually reside in a Member State, by a taxable person who has established his business or has a fixed establishment from which the service is

> supplied outside the Community or, in the absence of such a place of business or fixed establishment, has his permanent address or usually resides outside the Community, shall be the place where the non-taxable person is established, has his permanent address or usually resides.'

While if the customer is located outside the Community by a business established in the EU that transaction would not fall under the tax jurisdiction of any Member State and would thus not be subject to VAT.

Sec. 9 (3) enabled EU members to implement special tax rules to avoid 'double-taxation, non-taxation or the distortion of competition'. In practice this section would allow Member States to treat the place of supply that under Sec. 9 (2) would fall within the territory of a member country as being situated outside the Community 'where the effective use and enjoyment of the services take place outside the Community' and treat the place of supply that would normally fall outside the Community as actually being within the Member State 'where the effective use and enjoyment of the services take place within the territory of the country'.

The place of supply in the case of a transaction between a EU operator and a taxable person inside another Member State would be deemed the country where the recipient to the transaction was established. This envisages business-to-business transactions because the supply would be made to a taxable person and not to a private consumer. If on the other hand, the recipient of such a transaction was a private individual, but also a taxable person located in the same Member State of the supplier, the place of supply would now be the place where the supplier was located.

Article 9, paragraph 4 is amended as follows:

> 'In the case of telecommunications services and radio and television broadcasting services referred to in paragraph 2 (e) when performed for non-taxable persons who are established, have their permanent address or usually reside in a Member State, by a taxable person who has established his business or has a fixed establishment from which the service is supplied outside the Community, or in the absence of such a place of business or fixed establishment, has his permanent address or usually resides outside the Community, Member States shall make use of paragraph 3 (b).'

By means of the new Sec. 9 (4) EU members could change the determination of the place of supply by virtue of Sec. 9 (3b) in the case of services to non-taxable persons in the EU by non-EU ISPs when such services are 'effectively used or enjoyed' in Community territory. Sec. 9 (3b) however can only be applied in the case when the services were supplied to 'non-taxable persons established' and not necessarily to EU residents only. This presents a much wider net for VAT taxation including non-Europeans using or enjoying ISP services of non-EU providers while passing through Community territory. It was argued that this could potentially have double-taxation implications. In practice, therefore this allowed Member States to tax intangible services supplied from non-EU Member States to non-taxable customers using or enjoying such services within their country.

The Commission proposed to amend the basic rule of the Directive to allow the place of supply for the supply of such services, not to the place where the services are physically carried out, but to the place where the customer either:

> (i) has established his business; or
>
> (ii) has his or one of his fixed establishments to where the given service is actually supplied on in the absence of either (i) or (ii), where the customer:
>
> (iii) has his permanent address or usually resides.

There would be no tax to collect on free downloads, free information or free access to the Internet as VAT is not generally a consideration when no charge is made. The Commission also pointed out in an accompanying note to its original proposal that nothing will change in respect of services where the Internet was only used as a channel of communication between the supplier and the customer.

The Proposal added Article 26c for non-established taxable persons supplying electronic services to non-taxable persons; the article provided definitions and Special scheme for services supplied electronically. The proposal permitted a non-established taxable person supplying electronic services to a non-taxable person who was established or had his permanent address or usually resides in a Member State, to use the special scheme in accordance with the provisions laid down in the proposal. Non-EU suppliers were allowed to register in a single member state under the 'special scheme,' but they would have to be able to account for VAT in all of the EU member states in which they had 'final' consumers and further they would be required to levy VAT on those transactions with EU consumers if their revenues exceed a certain threshold amount.

In addition, tax administrators would provide operators with the means to distinguish easily the status of their customers (whether the customer is a VAT registered business or a private customer), and this would provide a means whereby any supplier acting in good faith would be able to determine whether or not a transaction should be charged with VAT. In order to facilitate the introduction of the new system, non-EU suppliers would be offered a simplified online registration and compliance mechanism that would allow them to fulfil their VAT duties without establishing a physical presence or 'fiscal representative' within the EU. However, they must register with the chosen authority by providing information including name, postal and electronic addresses, web sites, national tax number and a statement that the company was not already identified for VAT purposes in the EU. The chosen tax authority would then provide the supplier with a dedicated number by email after which the supplier must submit a quarterly VAT return that includes details on the total value of sales and tax collected in each Member State. The supplier then have to remit tax collected to the tax authority that is then responsible for reallocating the VAT revenues among the other member state.

The application of VAT for electronic services supplied from one member state to consumers in another member state within the EU would be charged at the applicable rate in the member state where the supplier is registered. For Non-EU suppliers the directive, in its current form, does not address the issue of tax rates specifically, but the Commission would undertake a general review of all aspects of these tax rates shortly as part of its quest to modernize VAT. It is clear that a 'standard' tax rate will be established for each country within the EU, and non-EU suppliers will levy VAT according to the 'standard' tax rate of the Member State within which they are registered. Under the scheme for supplies made to third countries VAT would be levied at a rate applicable in the Member State where the customer is a resident, and revenue will be re-allocated to that state after a purchase is made The suppliers would also have make tax records available to member state of where they register and those member state where their consumers reside. They should keep such records for ten years after the sale. Member States have agreed that this system should be applied for three years following implementation of the Directive and then be extended or revised. According to the European Commission:

> 'the single registration model offers a streamlined set of obligations, which can be easily completed, online without the need for a fiscal representative or for any physical presence. This special registration scheme will be easier to operate and more business friendly than rules for non-resident businesses generally'.

5. Criticism and Defence

The proposal had been subject of severe criticism by non-Europeans who will have to collect VAT on sales to customers in the EU and remit the tax to a VAT authority in the Member State of registration. As has already been mentioned earlier the majority of critics fare from the US. While this proposal sounds unassuming at first, there are several potential concerns. Since VAT rates differ according to EU member states, the accounting could become a bit tricky. The standard VAT rates currently range between 15% in Luxembourg to 25% in Denmark or Sweden. Thus, any non-EU firm providing services to EU residents must keep track of their customers' locations in order to properly assign taxes. Thus, if a non-EU operator decides to register in Great Britain and makes sales to individuals in France, Germany, and Sweden, the operator will need to know that the rates to be applied at the customer location are 19.6 percent, 16 percent and 25 percent, respectively. Further it also means that a book delivered online will subject to the standard tax rate while, the same book delivered in physical form may be subject to a lesser rate, or even a zero rate. It is unclear whether this discrepancy will be remedied. If no steps are taken to remedy it, a situation may arise in which the rate applicable to certain electronic media will differ greatly from the rate applicable to the same product when it is physically delivered.

The problem, as the United States sees it, is that while EU companies charge tax based on where their headquarters is located, Non- EU companies would be required to charge tax based on where the buyer lives. That means European companies could charge a flat tax rate for all purchases made by European customers, while U.S. and other non-EU companies would have to determine where each buyer resides before calculating tax. Such a process would place a significant administrative and technological burden on US

e-tailers.
A letter from the US Council for International Business to Commissioner Bolkestein on February 7 2002 effectively summaries the concerns expressed on behalf of businesses:

- Proving a customer's location is difficult and may result in greater business costs for businesses;

- Services are not being treated equally to goods since they are standard-rated, and, in many jurisdictions, the equivalent goods enjoy a reduction in the applicable rate;

- Rate discrimination results from the fact that non-EU operators' tax burdens will be greater than that of EU operators who can charge a lower rate of VAT to EU customers if they are tax-registered in a low-tax jurisdiction (such as Luxembourg);

- Non-EU operators will face administrative burdens that are not sufficiently spelled out yet and may result in significant costs.

The proposal could be 'a significant problem' for US and other Non-EU e-tailers, Gartner analyst French Caldwell told the E-Commerce Times. It also could cause international conflict. Gartner previously has predicted that differences between EU and US tax laws will become a major source of friction in international trade by 2003. In a report released by the research firm said:

> 'The EU's decision to move forward with its proposals raises the probability'.

The Bush administration has 'serious concerns' about the proposal and indicated that the plan may violate existing treaties and rules set out by the World Trade Organization. US Deputy Treasury Secretary Kenneth Dam called for:

> 'further efforts to achieve a more global consensus that reflects a consideration of all the issues raised'.

He pointed to current discussions on e-commerce tax issues being held at the OECD. He further added:

> 'The proposal may potentially be inconsistent with international trade obligations in the World Trade Organization, in particular the commitment to accord national treatment to foreign goods and services. The concept of one set of countries imposing a consumption tax regime on other nations is perhaps most troublesome of all. Unilateral proposals such as this may encourage others to take unilateral measures, rather than waiting for the global consensus that can be developed through a deliberative and inclusive process, such as the OECD's'.

Hardesty expressed similar concern that the unilateral impetus in the EU to tax electronically delivered products might trigger a world-wide reaction with many countries following on the steps of the Commission and enacting laws that will allow them to levy indirect taxes on all electronic deliveries that are finally consumed within their territory, irrelevantly of their country of origin. This would make e-businesses wrestle with tens of different VAT regimes worldwide and the burdens of compliance would be so immense that non-compliance would be the order of the day. The EU argues, however, that the new directives simply removes a competitive handicap by not levying the VAT outside the EU and by subjecting non-EU suppliers to the same VAT rules as EU suppliers when providing electronic services to EU customers.

Caldwell on the other hand pointed out that even if the policy were approved, it would be unenforceable, because it will be impossible to determine whether a EU consumer has downloaded digital goods from a server based outside the EU:

> ‘And how are you going to charge VAT on Web services? That's the next thing’, Caldwell added.

There may even be legal trouble. The US Supreme Court has ruled that companies cannot be forced to collect taxes on interstate sales when they do not have a physical presence in the consumer's state. According to the Gartner report, if that ruling is extends to international sales, US companies could be legally barred from collecting value-added tax on behalf of EU countries. In the end, the EU's proposed policy may come back to haunt it.

‘The bigger problem is not for the US companies, it's a problem for EU companies potentially locked out of the US market if the US decides to retaliate’.

Further, this would likely to add to a series of disagreements between the US and the EU over trade, including the dispute over new US steel import duties.

The Directive had not provided a comprehensive definition of what digital goods and services are covered. The list seems to be unsatisfactory in respect of the novel types of service as well. Due to dynamic evolution of the Internet and e-commerce, there are already some services, which would fall outside the scope of subsection (2e). The taxation of these services, therefore, would also happen according to the general place-of-supply rule. The next issue of concern is the over-complication of the place-of-supply rules that would follow from the adoption of the proposed amendments to Article 9 of the Sixth Directive. Further more the proposal is salient on the issue of how can the consumer’s jurisdiction be accurately identified? To assess which Member State rate is applicable to the sale the Non-EU suppliers are going to have to be able to verify their customers’ identity (business or final consumer) and jurisdiction in a real-time, on-line environment. Many companies have stressed that the technology is not yet available to do achieve this with 100% accuracy.

The compliance regime for non-EU suppliers will be more onerous than their EU based counterparts. The US Treasury has argued that while a European company will be able to charge the same tax rate to every European customer, US businesses will have to calculate the tax rate for each European customer who buys a download, based on the country they live in. Industry groups argue the new directive will cost large companies business and make it difficult for smaller firms to sell digital products in Europe. The EU has argued that the special scheme is its best effort at lightening the compliance regime. It should be noted that the process of registration for non-EU suppliers applies only to 'a non-established taxable person', and not to anyone who is already established or has a fixed establishment for VAT purposes in any EU state. Some businesses may find it advantageous to make sure their activities are within the new registration regime, though others may find it an advantage to create an establishment in the EU and account for VAT under the existing regime. The preferred course of action will depend on the individual circumstances of each business.

Hardesty also highlighted another shortcoming in the proposal. In its explanatory memorandum to the June 2000 proposal the Commission briefly explained the ways in which it was planning to ensure compliance to the suggested amendments. The key to the EU's enforcement of these new rules is online identification of consumers. As of now, technology would not allow the online seller to verify the location of a consumer or whether the consumer is VAT registered. The directive assumes that this technology would become available, but if it is not, the entire directive becomes unenforceable. The proposal itself is absolutely silent on how compliance is to be ensured and therefore leads one to deduce that the mechanisms for compliance would be constructed on those already used for traditional commerce. However, the intangible nature of e-commerce gives rise to new problems of compliance peculiar to this new way of buying and selling things electronically. The proposal provides no detail as to how the EU national VAT authorities will be able to trace non-compliant businesses, irrelevantly if these are operating from inside or outside the Community. Hardesty however predicted that the EU competitors of offending non-EU companies would have an interest in reporting them and tip tax authorities on where to look for non-compliance. This is not a practical solution that can be offering any degree of predictability. Even if the national VAT authorities, following tip-offs or some other system, identify non-EU companies which are not compliant with the requirements of the suggested amendments, there would be another problem on enforcement and particularly in collecting the unpaid VAT due. Once again, although the explanatory memorandum hints at what might be the tools used for the enforcement of VAT rules on non-EU sellers, the proposal itself contains nothing on the matter. The Commission suggested that non-EU companies would have an interest in collecting VAT on sale to EU customers because the EU framework would be already protecting their intellectual property rights within Community territory. In other words, this is a form of give and take situation. Nevertheless, give and take situations are not law and it is not unheard of how people with an interest to make a profit take and much as they can and do not give. Various other solutions have been suggested, although not by the Commission itself.

6. Conclusion

Technology will eventually be used to make compliance easier. People associated with the development and implementation of the Directive believes that work should be aimed at a future solution that is based on technology. However, it obliviously remains to be seen what technological development makes it possible to accurately identify the location of the customer and simplify the compliance mechanism and effectively identify and punish the non-compliant. The UK government got backing for the idea of developing an online VAT payments system for the whole of Europe but the details of this idea remain sketchy.

Indeed developments in technology are indispensable for collection of consumption taxes on e-commerce to provide an automated tax charging and collection mechanism. There are also vide range of proposed solutions based on re-creation of intermediaries (using of ISP or financial intermediaries) to withhold and remit tax to the appropriate tax administration, however and ideal solution in my view would be a balanced utilization of both. There are certain aspects of the proposals, such as the on-line VAT registration, on-line return filing, and on-line accounting by EU or non-EU businesses, where development of technology would be essential to materialise. If the technology were not in place, the sections allowing businesses to file VAT returns electronically would be achieving absolutely nothing in practice. It was suggested that in the near future technology would be enable the EU simply to shut-off access by all computers in the Community to the non-compliant web-sites. Big software developers such as IBM and Taxware International are already promoting software solutions that help non-EU companies to collect EU VAT on their on-line sales. If the proposal makes it through, such software applications would be an indispensable tool for all non-EU operators. Hardesty believes:

> ‘however, it is unlikely technology will be the easy panacea government officials hope’.

Cynicism about the EU's ability to enforce these rules is a natural response. Without doubt, enforcing compliance and implementation will be the most difficult task facing EU governments and tax authorities. Ideally, there will be a EU-wide consensus on the verification standards and changes to be adopted across the EU. Businesses involved in the supply of electronic services will have little time for implementation if the July 2003 introduction date is adhered to.