

The E-VAT Directive: Mitigating Tax Competition or Spurring It? *

Oleksandr Pastukhov, LL.M. (Northwestern)

Associate Researcher, Center for Law and ICT (ICRI)

K.U.Leuven, Leuven 3000, Belgium

Abstract. Turnover taxes are generally considered to be risk-free from the tax competition point of view, for they are levied exclusively at the place of consumption. The Value-Added Tax (VAT) imposed by all European Union (EU) member states, though, has become a source of distortion in the trans-Atlantic trade: non-EU suppliers of electronic services were not required to collect the VAT, while their EU competitors were. The level playing field in EU's foreign trade in electronic services was restored in 2002 by the so-called e-VAT Directive that obliged non-EU providers of electronic services to charge the VAT at the rate of the member state their consumer resides in. This paper argues that besides being largely unenforceable, the Directive has created another misbalance in the infra-EU electronic commerce. It is being demonstrated that since the Directive is not applicable to EU vendors, non-EU businesses can and do circumvent it by establishing daughter companies in EU jurisdictions with the lowest VAT rates and thus spur the infra-EU tax competition.

1. Tax competition in turnover taxes

The Value-Added Tax (VAT) is universally considered less exposed to the risk of harmful tax competition than direct taxes and especially corporate income taxes. There are several reasons for this. First, turnover tax bases are generally less mobile than those of the income tax. Although trans-border shopping has been known for quite a while now, consumers are normally less inventive in matters of tax minimization than entrepreneurs.

Second, since turnover taxes of the VAT type are typically included in every end product's price and are paid by final consumers, they are not a cost factor for businesses. The latter can hardly avoid collecting indirect taxes imposed by any jurisdiction, unless they sell their products in specially designated tax-free zones, international waters, Antarctica or, more realistically, cyberspace.

Third, such taxes are normally applied according to the destination principle in cross-border transactions. This is not a result of a treaty, but rather of a silent consent.

Moreover, VAT rates are not as diverse as income tax rates, a standard rate of around 20% being normal (Deloitte, 2006). In the European Union (EU), where the VAT is a subject of advanced harmonization, the minimum rate of 15% and a restrictive list of goods and services eligible for a reduced rate or exemption were introduced (Sixth Directive, 1977).

Finally, international market forces lead countries to align tax rates to those of their trading partners and thus remain competitive in attracting international business. For most of the EU member states, membership in the European Monetary Union is an additional institutional and political factor contributing to the ongoing process of 'spontaneous' tax harmonization.

2. The EU initiative

The above said does not mean that there is no opportunity for intra-jurisdictional tax competition in turnover taxes or harmful practices in this realm. It is namely the EU that has addressed the problem of unequal competitive playing field effects caused by the existence of low and no-VAT jurisdictions, which naturally attract volatile Internet businesses wishing to sell goods or services in countries with higher VAT rates. Thus, harmful tax competition between the EU member states was recognized by the Commission "possible insofar as divergences in the application of the current ... VAT system impact on transnational economic activities or on activities in a neighbouring Member State" (Towards tax co-ordination, 1977). Differences in indirect taxation of investment gold, passenger transport services and energy products were mentioned among tax distortions to the infra-community trade (Ibid, p. 9).

* A version of this paper was published in Kierkegaard, S. (2006) Business Law and Technology Vol. 1 and presented in the 2006 IBLT Conference, Denmark.

The distortions to economic competition and perceived tax leakage that came to the Commission's attention resulted from the fact that non-EU providers of electronically supplied services (including Internet access and digital downloads) were not obliged to account for the VAT in the member states, whereas their EU competitors had to do so and thus were significantly disadvantaged.

In 2002, a special directive (Directive 2002/38/EC, 2002) was adopted in order to ensure that the EU VAT regime no longer provided an unjust competitive advantage to non-EU businesses over their EU counterparts and that electronic services consumed within the member states were duly taxed. New legislation was required in each of the then-15 member states to implement the new rules by July 1, 2003. Initially, the Directive was set to expire after three years (Art. 4), but on June 27, 2006, it was extended until December 31 of the same year (Directive 2006/58/EC, 2006).

The Directive principally affects "electronically supplied services", or simply "electronic services", which are described in the Annex thereto through the use of the following illustrative examples:

- Website supply, Web hosting, distance maintenance of programs and equipment;
- supply of software;
- supply of images, text and information;
- supply of music, film and games; and
- supply of distance teaching (Directive 2002/38/EC, 2002 p. 44).

Under the Directive, the place of supply of electronic services is determined by reference to the place where the customer is located. This does not affect the existing VAT treatment of such supplies between a non-EU supplier and an EU business customer. The reason for B2B commerce not being covered is that the business customer is required to self-assess local VAT under the "reverse charge" mechanism. The non-EU supplier is required to account for the VAT at the rate prevailing in the EU country in which the customer is located. The notion of a non-business customer includes private individuals, as well as some local authorities, government organisations, and certain schools and colleges (having a VAT registration number is normally a good indicator of a business customer).

The Directive could potentially result in a non-EU supplier having to register for VAT in every EU member state in which it has non-business customers. However, the Directive provides for a simplification, whereby the non-EU supplier can opt to register for VAT purposes in one member state only, although it will still be required to charge and account for the VAT at the prevailing rate where each of its customers is located.

3. The EU approach's drawbacks

Being designed to remove an inequity that existed in the EU indirect taxation and close the door for tax competition between low- and no-VAT jurisdictions and EU member states with their relatively high VAT rates, the Directive, at the same time, creates new opportunities for intra-community VAT competition in two ways. First, upon registering under the new rules, non-EU businesses need to charge a higher rate of VAT in some countries than their EU competitors. For example, a non-EU VAT-registered business needs to charge the VAT at 25% to individuals in Sweden or Denmark, but a competitor from Luxembourg supplying to individuals in those countries would only need to charge Luxembourg VAT at 15%, which allows the Luxembourg business to set its prices at 10% lower. This became possible because EU suppliers of electronic services are not affected by the Directive and therefore the place of supply of their services is determined by where they are established rather than by where their customers are located.

Second, the new VAT charge under the Directive can be mitigated altogether along with the additional administration of a special 25-section VAT return by creating an establishment in one of the EU member states. The question of what exactly constitutes a "fixed establishment" for VAT purposes has not been definitely resolved neither by member states' national laws nor by EU instruments. Thus, the French's official position is that "a commercial site does not constitute a permanent establishment for the purposes of the VAT" (*De Chazeaux*, 2000 p. 3263), whereas the Sixth Directive, in the services context, refers to "the place where the supplier has established his business or has a fixed establishment from which the service is supplied or, in the absence of such a place of business or fixed establishment, the place where he has his permanent address or usually resides" (Art. 9(1)). While the issue remains a subject of much case law, it is clear that an EU-established supplier is only required to register in the country in which it is established and charge only the prevailing rate of VAT of that country to all its non-business customers throughout the EU.

Both scenarios described above have lead Internet businesses to the natural decision to get established in the lowest VAT jurisdictions in the EU. With its standard rate of 15%, Luxembourg is an obvious choice. The

Portuguese island of Madeira, which actively promotes itself as a hub for electronic commerce and invests significantly in the infrastructure (Madeira E-Commerce), will maintain an even lower rate of 13% up to the end of the year 2011 (Madeira - VAT Capital). Although setting up a VAT establishment does not necessarily mean having a permanent establishment for corporate tax purposes as well, low direct tax rates in the same very jurisdictions make it even more lucrative to relocate there.

Besides the obvious saving on the VAT, establishing in a low VAT country or territory brings along other benefits. Compliance with only one VAT system and adopting a billing system to charge clients the VAT at a single rate is much simpler and cheaper than dealing with 25 systems and several different rates. In the earlier case, customer verification is not required at all. Moreover, VAT recovery is more efficient for EU-established businesses. While they are entitled to recover the VAT they incur through a regular VAT return, non-established businesses, including those registered under the Directive, are able to recover the VAT only by making normal Thirteenth Directive (Thirteenth Directive, 1986) refund claims, which is often a cumbersome and lengthy procedure.

All this being said, it is not surprising that AOL, a major American supplier of electronic services, announced its decision to relocate its European headquarters to Luxembourg in anticipation of the new rules (ISP AOL UK, 2003). Virgin.net and Freeserve followed the lead by relocating to Madeira (Watts, 2003). It is also logical to expect many non-EU Internet businesses to find themselves under pressure from competitors to either comply with the 'e-VAT' Directive or to circumvent it by establishing daughter companies in the EU. For the reasons discussed above, bigger and better known providers of electronic services will prefer circumvention to compliance and tax competition among the member states will plummet. Smaller providers with little or no assets in the EU will simply keep ignoring the Directive, for its provisions are downright unenforceable (Graff, 2000; Smith, 2003).

Nevertheless, the Commission prefers not to admit its obvious flop and keeps insisting that the "Directive has operated in a satisfactory manner and has achieved its objective of creating a level playing field for the taxation of electronic services" (VAT, 2006). Moreover, the Commission plans to enshrine the temporary rules of the Directive into two new directives that are to have permanent effect: one on the place of taxation of services whereby all broadcasting and electronically supplied services will be taxed at the place of consumption (Amended proposal, 2005) and the other one on the simplification of VAT obligations known as the proposal on the 'One Stop VAT Shop' (Proposal, 2004).

4. Conclusion

Both the E-VAT Directive and the proposals that are about to make its rules permanent adopted the Commission's fundamentally flawed logic of trying to tax things it can't possibly tax and not even trying to find things it can tax instead. At the same time, appearance of unenforceable rules is the result that should definitely be avoided, for as Warren (2002) rightly states "[i]f tax laws are not enforceable and taxpayers use the internet to play a *catch-us-if-you-can* game of tax avoidance and evasion, then the resulting tax system is neither efficient, nor equitable nor sustainable" (p. 89). Therefore, it seems rational for the Commission to renew its interest in alternative electronic commerce taxation schemes (Building, 1997) and give consideration to the relevant reformist proposals put forward by academics and practitioners from around the world (Pastukhov, in press).

References

1. Amended proposal for a Council Directive amending Directive 77/388/EEC as regards the place of supply of services. 20.7.2005. COM(2005) 334 final.
2. Building the European Information Society for Us All, Final Policy Report of the High Level Group of Experts (April 1997). Retrieved August 11 from <http://meritbbs.unimaas.nl/publications/2-hleg.pdf>
3. Council Directive 2002/38/EC of 7 May 2002 amending and amending temporarily Directive 77/388/EC as regards the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services, OJ L 128, 15.5.2002, p. 41.
4. Council Directive 2006/58/EC of 27 June 2006 amending Council Directive 2002/38/EC as regards the period of application of the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services, OJ L 175, 28.6.2006, p. 5.
5. *De Chazeaux*. Rep. Min. No. 39394, J.O.A.N.Q. 29.05.2000.
6. Deloitte Touche Tohmatsu (2006). Global Indirect Tax Rates. Retrieved August 11, 2006, from <http://www.deloitte.com/dtt/article/0,2297,sid%253D3880%2526cid%253D5028,00.html>

7. Smith, H. (2003). VAT and E-COMMERCE: Countdown to 1st July 2003. Retrieved August 11, 2006, from <http://www.herbertsmith.com/publications/publications.asp?id=>
8. ISP AOL UK Relocates & Pays V.A.T. ISP Review (May 2, 2003). Retrieved August 11, 2006, from <http://www.ispreview.co.uk/light1.php?search=ISP+aol+UK+Relocates+%26+Pays+V.A.T.>
9. Graff, J. (2000). Brussels Decrees an E-VAT, *Time Europe*, Volume 155, Number 24 (June 19, 2000). Retrieved August 11, 2006, from <http://www.time.com/time/europe/magazine/2000/0619/euvat.html>
10. Madeira - VAT Capital of the World? Retrieved August 11, 2006, from <http://www.lowtax.net/lowtax/html/jmdspec.html>
11. Madeira E-Commerce. Retrieved August 11, 2006, from <http://www.lowtax.net/lowtax/html/jmdecom.html>
12. Pastukhov, O. (in press). International Taxation of Income Derived from Electronic Commerce: Current Problems and Possible Solutions. *Boston University Journal of Science and Technology Law*.
13. Proposal for a Council Directive amending Directive 77/388/EEC with a view to simplifying value added tax obligations. 29.10.2004. COM(2004) 728 final.
14. Watts, R. (2003). Madeira: Europe's internet capital. Retrieved August 11, 2006, from <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2003/07/13/ccwatts13.xml>
15. Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment, OJ L 145, p. 1-40, as amended by Council Directive 2001/4/EC of 19 January 2001 amending the sixth Directive (77/388/EEC) on the common system of value added tax, with regard to the length of time during which the minimum standard rate is to be applied, OJ L 022, p. 17.
16. Thirteenth Council Directive 86/560/EEC of 17 November 1986 on the harmonization of the laws of the Member States relating to turnover taxes - Arrangements for the refund of value added tax to taxable persons not established in Community territory, OJ L 326, p. 40.
17. Towards tax co-ordination in the European Union. A package to tackle harmful tax competition. Communication from the Commission to the Council. 01.10.1997. COM (97) 495 final.
18. VAT: The European Commission proposes to extend the Directive on electronically delivered services. 16/05/2006. IP/06/621. Retrieved August 11, 2006, from <http://www.europa.eu.int/rapid/pressReleasesAction.do?reference=IP/06/621&format=HTML&aged=0&language=EN&guiLanguage=en>
19. Warren, N. (2002). Internet Challenge to Tax System Design. In Lymer, A. & Hasseldine, J. (Eds.), *The International Taxation System*. Boston, Mass.: Kluwer Academic Publishers (pp. 76-89).