A Progress Report on the EU's Efforts to Revamp Its VAT System

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In this article, the author discusses the EU's efforts to revamp the VAT system as envisaged by the 2016 VAT action plan and evaluates its progress on removing obstacles to e-commerce, implementing the definitive VAT system for intra-EU trade, simplifying the VAT compliance obligations for small and medium-size enterprises, and modernizing the VAT rate policy.

The VAT system for intra-EU trade, which dates from 1993, was intended to be transitional.[1] Under the transitional VAT system, the supply of goods transported to other member states gives rise to two taxable transactions: a zero-rated intracommunity supply in the country of departure and an intracommunity acquisition in the country of arrival. If the customer is entitled to an input VAT deduction, he can offset the VAT paid on the acquisition as deductible VAT in the same return and does not need to pay anything to the tax authorities.

The transitional system is complex and opens the door to fraud because it allows the purchase of goods VAT-free in other member states. Missing trader fraud occurs when a company that has purchased goods VAT-free from another EU state sells them domestically and fails to remit VAT it received on the sale. Past attempts by the European Commission to launch an in-depth reform of the EU VAT system failed because of the unanimity requirement for approving new legislation.

VAT fraud is one of the system's most serious problems. Generally, there are two main types of VAT fraud. The first includes fraudsters who manipulate their own liability to remit VAT (for example, by failing to register for VAT purposes, abusing differences in VAT rates, or collecting VAT but failing to remit it). The second concerns the mechanisms for input VAT recovery (for example, claiming VAT on fake purchases). It also includes situations when an entrepreneur deducts and receives input VAT from the tax authorities, but his supplier, who has charged and invoiced the VAT, never remitted it to the tax authorities (missing trader fraud). In 2016 the VAT gap, which provides an estimate of revenue loss resulting from tax fraud, bankruptcies, financial insolvencies, and miscalculations, was €147 billion. That equates to a total revenue loss across the EU of 12.3 percent. The largest VAT gaps were in Romania (35.88 percent), Greece (29.22 percent), and Italy (25.90 percent).[2]

[1] Article 402 of the VAT directive (2006/112) provides that the transitional rules must be replaced by definitive arrangements.

[2] Center for Social and Economic Research, "Study and Reports on the VAT Gap in the EU-28 Member States: 2018 Final Report," TAXUD/2015/CC/131 (Sept. 11, 2018).

Another inefficiency of the VAT system is the increased compliance burden for businesses engaged in intra-EU trade: They incur 11 percent higher compliance costs compared with those trading only in one EU country.[3] The main factors driving those extra compliance costs are the divergent application of the VAT rules among the EU states, and the additional compliance obligations for businesses engaged in cross-border trade. The extra costs are particularly burdensome for small and medium-size enterprises.

Given the inefficiency, costs, and fraud risks, the European Commission realized that it needed to change "business as usual." In April 2016 it published the VAT action plan (COM(2016) 148 final), which sets out the path to creating a single and fraud-proof EU VAT. It suggests removing VAT obstacles to e-commerce, implementing measures to address the VAT gap, simplifying compliance obligations for SMEs, implementing a definitive VAT system for intra-EU trade, and modernizing the VAT rate policy.

This article describes the modernization of the EU VAT system as envisaged by the 2016 action plan.

I. Removing VAT Obstacles to E-Commerce

On December 1, 2016, the European Commission presented legislative proposals to modernize and simplify VAT for cross-border e-commerce. The Economic and Financial Affairs Council approved most of the proposals December 5, 2017,[4] except the proposal on VAT on e-publications, which was approved nearly one year later.[5]

The e-commerce VAT package will be implemented gradually. Four measures took effect January 1, 2019. First, intra-EU supplies of telecommunications, broadcasting, and electronic services up to an annual turnover threshold of €10,000 remain subject to the VAT rules of the supplier's member state (origin principle). Second, suppliers whose annual turnover threshold does not exceed €100,000 may keep only one piece of evidence (instead of two) to identify the customer's member state. Third, for invoicing supplies of telecommunications, broadcasting, and electronic services, the rules of the supplier's member state will apply instead of the rules of the customer's member states.[6] Fourth, businesses not established in the EU but having a VAT registration in an EU state can make use of the one-stop shop (OSS) concept, meant to prevent registrations in multiple EU countries for non-EU businesses that supply telecommunications, broadcasting, and electronic services to private EU citizens (those services are subject to VAT in the customer's country).

The main measures of the e-commerce VAT package will enter into force January 1, 2021, and will implement far-reaching changes that require the adaptation of IT systems and electronic interfaces. First, online platforms will be deemed the supplier of goods sold to private EU individuals by companies using the platform when (1) intra-EU sales of goods are made by non-EU businesses, and (2) up to €150 in goods are imported. Consequently, online platforms will have to collect and pay the VAT on those sales. That could give rise to many practical problems. First, a platform that does not intervene in the payment process will be expected to collect and remit VAT and handle VAT reimbursements when goods are returned. Second, the OSS will be extended to all business-to-consumer supplies of services and intra-EU distance sales of goods, abolishing the current distance selling scheme.[7] Third, there will be a hybrid scheme for covering distance sales of goods with a value of up to €150

[3] European Commission, "European Commission Proposes Far-Reaching Reform of the EU VAT System" (Oct. 4, 2017).

[4] Council Directive (EU) 2017/2455, Council Implementing Regulation (EU) 2017/2459, and Council Regulation (EU) 2017/2454.

[5] ECOFIN reached political agreement on the proposal October 2, 2018, and approved the text of the directive November 6, 2018. The new directive will allow member states to apply reduced VAT rates to electronic publications.

[6] Although that is a major relief for business, tax administrations may have some trouble with the new rule. In the EU, the member state of consumption (not the member state of identification) retains power to audit taxable persons. Therefore, the member state of consumption will need to perform a VAT audit based on invoices drawn up in a different language and in accordance with other member states' rules. Because invoices are evidence of the right to deduct input VAT, tax authorities will have more difficulty determining whether the deduction right can be exercised.

[7] In the EU, there is a special VAT regime for distance sales of goods. The place of taxation of those supplies depends on the supplier's turnover from distance sales in the customer's country. VAT of the destination member state is applied if sales there exceed a threshold (€100,000; €35,000; or the equivalent in national currency). Distance sales below the threshold are taxed in the member state of origin. However, even if the threshold is not exceeded, suppliers can select the country of destination as the place of taxation.

imported from third countries to EU customers (it will replace the current VAT exemption for goods in small consignment with a value of up to €22):

- non-EU suppliers selling goods to nontaxable EU customers will be able to apply the OSS and declare and pay VAT monthly, and no VAT will be due on importation;
- if a platform facilitates the supply of goods, it will be responsible for VAT remittance because it will be deemed to have purchased and then sold the goods in question, and will be able to register for the OSS and pay VAT monthly;
- if no platform is involved and the supplier does not elect to use the OSS, the transporter of the goods (for example, a courier or postal service) must collect and remit VAT.

The hybrid scheme for low-value goods from third countries will cause many practical problems and open new opportunities for fraud. The customs infrastructure will need to be adapted because customs authorities will have to verify in real time the validity of the OSS registration numbers on the import declaration. Even if the real-time checks are performed, fraudulent suppliers will be able to import goods VAT-free by presenting a platform's OSS registration number and claiming that the platform facilitated the supply (when in fact no platform was involved).

II. A Definitive VAT System

On October 4, 2017, the European Commission presented several fundamental principles for a definitive VAT system.[8] It sought to replace the transitional VAT arrangements for intra-EU trade with the definitive system based on the destination principle.

Under the new system, the concepts of intracommunity supply and acquisition will be replaced by a single intraunion supply. The supplier will be required to charge the VAT rate of the country of arrival of the goods and remit the tax to his local tax administration via an OSS. If the customer to an intraunion supply is a certified taxable person (CTP), the supplier will not have to charge VAT and the customer will account for VAT using a reverse charge mechanism.

The CTP concept is new and has not been used in EU VAT law so far. It is similar to the authorized economic operator in customs law. CTP status will be granted to businesses that can demonstrate regular payment of taxes, financial solvency, and sound internal controls.

The definitive VAT system will require a substantial amount of trust and cooperation among tax administrators because the member state where the goods arrive will have to rely on the member state of departure to collect and remit the VAT due on the cross-border supply. Moreover, EU members will be required to accept CTP certifications issued by other countries. The proposal does not specify how to verify the solvency and reliability of companies that have been granted the CTP status or how to subsequently continuously monitor those conditions. Whether the definitive VAT system will contribute to preventing VAT fraud depends on how those functions will be carried out.

To improve the day-to-day functioning of the VAT system until the new, definitive regime has been implemented, the European Commission has proposed four "quick fixes," which ECOFIN approved October 2, 2018. Those interim measures, which will apply from January 1, 2020, seek to:

- provide a simplified and uniform treatment for call-off stock arrangements (in which the supplier makes goods available to the customer by placing them at or nearby the customer's premises but remains the owner of the goods during their storage);[9]
- establish uniform criteria for chain (ABC) transactions;[10]

[8] COM(2017) 567 final, COM(2017) 568 final, and COM(2017) 569 final.

[9] Under the new rules, the transfer of goods to another member state to the call-off stock warehouse will be ignored for VAT purposes. When the customer removes goods from the stock, two taxable transactions will take place: an intracommunity supply by the supplier in the member state of departure, and an intracommunity acquisition by the customer in the member state where the stock is located.

[10] Under the new rules, the intracommunity transport will by default be assigned to the first supply (from A to B), which will benefit from the zero rate for intracommunity transactions. The middle person (B) may allocate the transport to the second supply (from B to C) by communicating to his supplier (A) the VAT number issued to him by the member state the goods come from.

- make the VAT identification number a substantive condition to benefit from the zero rate for intracommunity supplies; and
- provide a common framework for the documentary evidence required to apply the zero rate to intracommunity supplies.

III. A Simplification Package for SMEs

Under the EU VAT rules, member states may exempt from VAT or from some VAT obligations businesses whose turnover is below thresholds. Those simplification measures vary by state and apply only to businesses established in that state — that is, EU members are not required to grant the benefits of the special scheme to nonresident SMEs. Thus, there is no level playing field for EU SMEs, and the increased compliance costs for those trading cross-border could seriously impede growth. Once the definitive VAT system is in place, the compliance costs could increase even more because the intraunion supply of goods will no longer be zero rated but instead subject to the destination country's VAT. Suppliers will therefore need to become familiar with the VAT rules of the other member states to which they supply goods. As discussed above, the supplier will not have to charge the destination country's VAT if its customer is a CTP.

On January 18, 2018, the European Commission proposed simplification measures to reduce VAT compliance costs for SMEs.[11] It envisaged a cost reduction by as much as 18 percent annually. The proposal would allow member states to continue exempting from VAT SMEs with a maximum turnover of €85,000 in one member state — a benefit that should also be available to SMEs established in other member states. Also, a safeguard revenue threshold of €100,000 across the EU will prevent companies with large turnover from using the small business exemption. The proposal also would allow EU members to introduce simplified compliance obligations for businesses with an annual EU turnover of up to €2 million. ECOFIN has not yet approved the proposal.

The proposed legislation will take effect only when the definitive VAT system has been implemented. It is a positive development that will simplify compliance for SMEs engaged in cross-border trade; however, the definitive VAT system has features that could put small businesses at a disadvantage compared with their larger competitors. CTP status will be granted to entrepreneurs that can demonstrate financial solvency, a good compliance record, and a high level of operational control. That implies that larger companies with well-established administrative processes and tax control frameworks will be more likely to be granted CTP status than small enterprises that rarely have their financial accounts checked by an external auditor.

IV. Modernizing the VAT Rate Policy

Member states may adopt one standard rate of at least 15 percent and two reduced rates of no less than 5 percent.[12] The reduced rates may apply only to supplies of goods and services mentioned in Annex III of the VAT directive (2006/112). The directive also allows some derogations from the rate provisions, transitional measures, and grandfathering clauses.

The VAT rate framework was adopted for an origin-based VAT system. At the time, a level of harmonization was necessary to avoid distortion of competition because origin-based taxation would favor suppliers in member states with low tax rates. The European Commission's recent proposal to move to a definitive VAT system based on the destination principle creates opportunities for using reduced rates with no risk of competition distortion.

On January 18, 2018, the European Commission released a proposal for reforming the VAT rate system. Under the proposal, the list of goods and services to which the reduced rates may be applied will be replaced by a list of products to which the standard rate of a minimum of 15 percent must be applied. In addition to the two reduced rates of a minimum of 5 percent, member states will be allowed to apply a third reduced rate between 0 and 5 percent. To safeguard public revenue, EU members must ensure that the weighted average of all VAT rates applied is at least 12 percent. The commission

[11] COM(2018) 21 final.

[12] VAT Directive (2006/112), articles 97-98.

linked the entry into force of the proposal for reforming the VAT rates to the implementation of the definitive VAT system.

The proposal will give member states more flexibility in applying the reduced rates, which will no longer be limited to the supplies listed in Annex III. A new list will determine which products cannot benefit from reduced rates (for example, jewelry, excise goods, and alcohol). There is a risk that expanding member state autonomy for the rate policy will be misused. Members could succumb to lobbying groups that seek benefits for various industries, a problem that does not now exit because the rate policy is determined at the EU level.

The application of different rates within a country could increase the VAT gap.[13] Multiple rates encourage businesses to benefit from the misapplication of reduced and super-reduced rates. The proposal to give member states more flexibility in the application of the reduced rates seems to be at odds with the objective of closing the VAT gap.

V. Conclusion

The European Commission has made progress toward achieving the objectives in the 2016 VAT action plan. The VAT e-commerce package has been adopted and will gradually be implemented between 2019 and 2021. It provides some simplification (origin taxation, simpler customer identification, and the possibility of using the OSS for non-EU businesses with an EU VAT number). However, it also entails measures that run counter to the stated objective of a simple and strong VAT system. The proposed system for the importation of goods valued up to €150 opens new possibilities for fraud, and the new liability rules for online platforms will increase risks and complexity for operators of electronic marketplaces.

However, the commission's proposals on the definitive VAT system, VAT rate policy, and simplification measures for SMEs still require unanimous member approval.

Implementing a definitive system seems a Sisyphean task because the commission's efforts to replace the transitional VAT arrangements have been unsuccessful since 1993. According to the commission's proposals, the cornerstones of the definitive VAT system should take effect in 2022. It is unclear whether that deadline will be met because two years is a short time for major reform. In the short term, the implementation of the four quick fixes beginning January 1, 2020, will lead to a more uniform application of the EU VAT system and increase legal certainty for businesses engaged in intra-EU trade.

The proposed rules on the VAT rate policy and the simplification measures for SMEs will take effect only if the definitive system has been implemented. It is unclear why the European Commission decided to interlink those proposals: It is easier to implement small adjustments rather than reach unanimity on major reform of the entire VAT system. Giving member states more discretion in determining the rate policy runs counter to the goal of closing the VAT gap and could make EU members succumb to pressure from lobbying groups.

The bottom line is that even if the definitive VAT system is implemented, there will still not be a single, simple, fraud-proof EU VAT as envisaged by the European Commission. ■

[13] *See* 2018 final report, *supra* note 2.