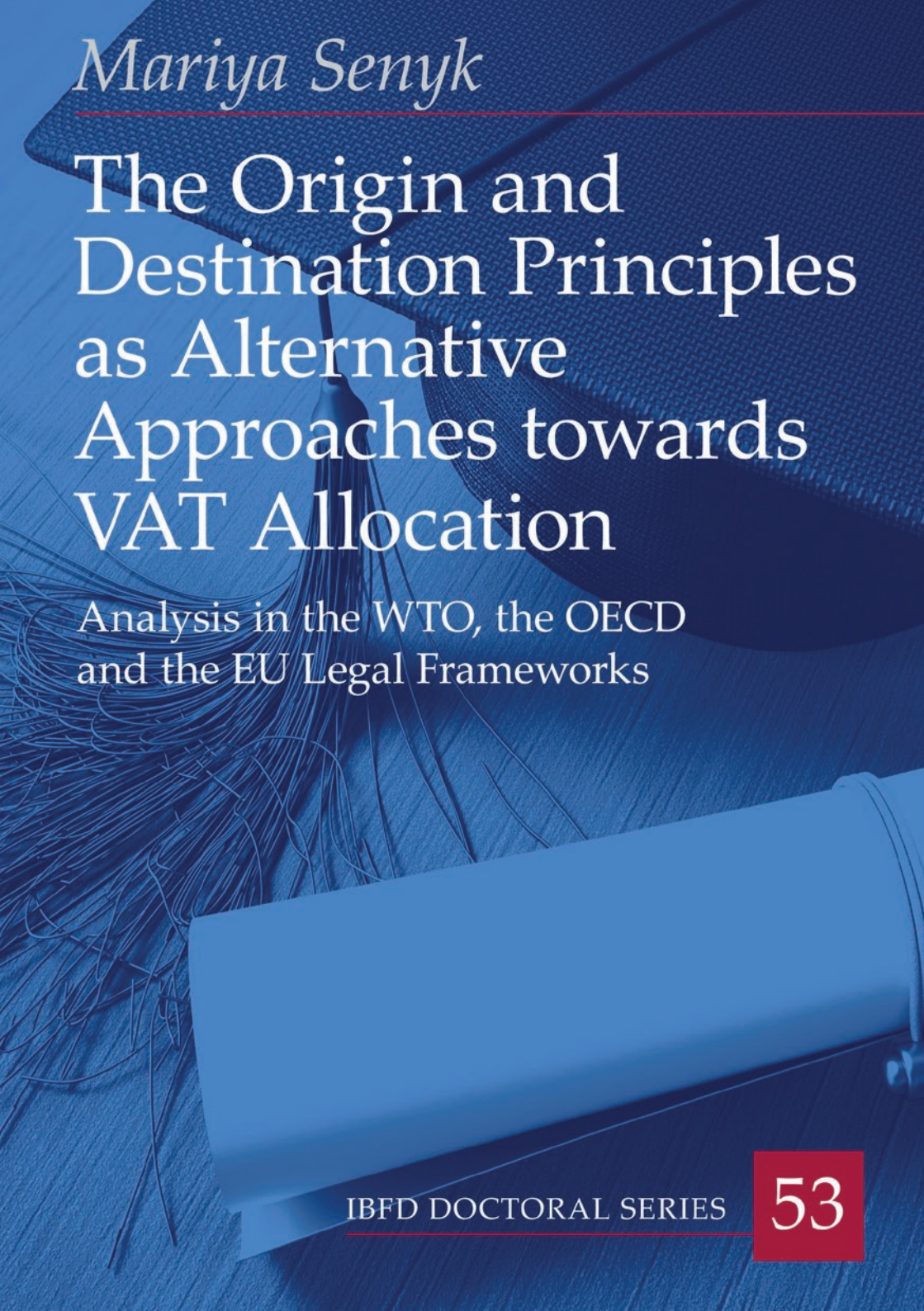
*Mariya Senyk*

# The Origin and Destination Principles as Alternative Approaches towards VAT Allocation

## Analysis in the WTO, the OECD and the EU Legal Frameworks



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# The Origin and Destination Principles as Alternative Approaches towards VAT Allocation

**Why this book?**

The origin and destination principles are the two main principles used by the OECD, EU policymakers and scholars when it comes to determining the jurisdictional reach of VAT. Although widely discussed, there is no common understanding of these principles. This not only results in confusion in the communication between legal actors, but, more importantly, can lead to different legal outcomes. Another legal issue is whether the origin and destination principles have a coercive effect: does the WTO compel its members to apply the destination principle? Can the origin and destination principles be used as a legal basis for determining taxing jurisdiction in the European Union? Yet another issue is whether consumption-type VAT may be based on the origin principle, particularly in a tax union in respect of VAT, such as the European Union.

This book provides a new perspective for understanding the origin and destination principles by analysing them in three international legal frameworks, namely the WTO legal order, the OECD framework and the EU legal order. Furthermore, it contains an analysis of the current and the proposed European VAT systems from the perspective of VAT allocation. One of the questions addressed in the book is whether the proposed definitive EU VAT system may be regarded as a destination-based system. At the end of the book, conclusions are presented regarding which of the two principles is preferable for the allocation of VAT in the internal market of the European Union.

This book should be of use for policymakers and other legal actors seeking to develop a deeper understanding of the origin and destination principles and their application in the internal market of the European Union.


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*Visitors' address:*
Rietlandpark 301
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*Postal address:*
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The Netherlands

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# Abstract

When it comes to determining the jurisdictional reach of VAT, two principles are used by the OECD, EU policy makers and scholars, namely, the origin principle and the destination principle. These principles can mean different things. One problem is that different constructions thereof can result in confusion in the communication between legal actors and, more importantly – in different legal outcomes. Another legal issue is whether the origin and destination principles have a coercive effect. In particular, the OECD considers the destination principle to be an "international norm" that is "sanctioned" by WTO rules. However, is it really so? Does the WTO compel its members to apply the destination principle or is it a matter of choice in furtherance of the intention to achieve neutrality in international trade?

The aim of this book is to bring clarity to the understanding of the origin and destination principles and to prompt policy makers to be more accurate in their use of terminology when drafting legislation. In pursuit of this objective, these principles are studied in three international legal frameworks, namely the WTO legal order, the OECD framework and the EU legal order. The study also addresses the question of the principles' legal status in each of the selected legal frameworks. Furthermore, an evaluation is undertaken of the origin and destination principles from the perspective of the legal character of VAT as a tax on consumption. It is claimed in this book that a consumption-type VAT may also be based on the origin principle subject to certain conditions.

Also addressed is the issue of the allocation of VAT in the European Union. The results of the analysis demonstrate that the different derogations available to the Member States with regard to the current EU VAT system make it an extremely complex and fragmented system. Furthermore, the proposed definitive VAT system also remains hybrid, i.e. it is based on both the origin and destination principles. The end of the book presents conclusions regarding which of the two principles is preferable for the allocation of VAT in the internal market of the European Union.

This book should be of use for policy makers and other legal actors seeking to develop a deeper understanding of the origin and destination principles and their application in the internal market of the European Union.

# Chapter 1

# Introduction

## 1.1. Background

In 2011, the European Commission[1] announced a change from the principle of "taxation in the Member State of origin of the supply of goods or services", which was stated as the policy goal in article 402 of the VAT Directive,[2] to the principle of "taxation in the Member State of destination". The main driver for changing the current EU value added tax (VAT) system is the VAT gap, i.e. the amount of VAT lost due to tax fraud,[3] the foremost cause of which has been the current exemption of intra-EU supplies of goods. This is also known as missing trader intra-Community (MTIC) fraud.[4] In October 2017, the Commission adopted a number of proposals for the creation of the Single EU VAT Area including a proposal introducing a new definitive VAT system for the taxation of trade between Member States, followed by a proposal on the detailed technical measures for the definitive VAT system. In December 2017, new legislative acts concerning the establishment of the Digital Single Market[5] (DSM) were adopted. However, one might question whether it is truly a so-called "fundamental principle" that is being changed and also what the policymakers actually mean when they refer to the destination principle. Furthermore, why is it

1. Hereinafter referred to as the "Commission".
2. Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 347/1 (11 Dec. 2006), Primary Sources IBFD.
3. According to studies, in 2016 the EU VAT gap amounted to EUR 147.1 billion. *See* 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.
4. MTIC fraud occurs when a fraudulent business buys goods from a supplier in another Member State and then sells them to a customer in its Member State and charges VAT on the goods. The fraudulent business (missing trader) disappears with the collected VAT without paying it to the tax authorities. The purchaser, which could be unaware of fraud, claims VAT deduction in respect of goods purchased from the fraudster.
5. A Digital Single Market is defined as "one in which the free movement of goods, services, persons and capital is ensured and where individuals and businesses can seamlessly access and exercise online activities under conditions of fair competition, and a high level of consumer and personal data protection, irrespective of their nationality or place of residence". *See* Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – A Digital Single Market Strategy for Europe, COM(2015) 192 final, Primary Sources IBFD.

that the fundamental ideas for the origin-based EU VAT system that existed until 2011 have eventually been abandoned?

In the field of territorial allocation of VAT, two competing so-called "principles" are mentioned in the literature, namely, the origin principle and the destination principle. The destination principle put into practice by border tax adjustment provisions is permitted by the rules of the World Trade Organisation (WTO). It is not clear, however, whether the WTO imposes any restrictions as to the application of the origin principle. The origin principle and destination principle are also employed by the Organisation for Economic Co-operation and Development (OECD) in the context of its work in the field of VAT and by EU policymakers. Thus, the OECD points out that it is a "fundamental issue of economic policy" to decide whether VAT in cross-border trade should be imposed by the jurisdiction of origin or that of destination.[6]

The aforementioned principles are also referred to in the literature as: "jurisdictional principles";[7] the "two major methods of defining the jurisdictional reach of VAT";[8] "principles underlying the jurisdictional rules";[9] and even as "rules".[10] The EU policymakers, in particular the Commission, interchangeably call them "principles" and "rules". No matter what they are called, the purpose of both principles is to outline the jurisdictional reach of VAT in cross-border trade and consequently to allocate the taxing rights to a particular jurisdiction.[11] In view of this, the author has chosen to refer to these principles as "alternative approaches towards the allocation of VAT".

There is no common understanding of exactly how the origin principle and the destination principle are to be construed. It is remarkable that in official

6. OECD, *International VAT/GST Guidelines* (OECD 2017) (hereinafter the Guidelines), para. 1.8. Hereinafter, unless otherwise specified, reference to the Guidelines concerns the final version of the Guidelines published on 12 Apr. 2017.
7. R. Millar, *The Destination Principle: Past Developments and Future Challenges*, 12 Sydney Law School Research Paper 33, p. 4 (2012); C.K. Sullivan, *The Search for Tax Principles in the European Economic Community* p. 45 (Law School of Harvard University 1963); C.K. Sullivan, *The Tax on Value Added* p. 30 (Columbia University Press 1965).
8. A. Schenk, V. Thuronyi & W. Cui, *Value Added Tax. A Comparative Approach* p. 188 (second edn., Cambridge Tax Law Series 2015).
9. R. Millar, *Jurisdictional Reach of VAT*, in *VAT IN AFRICA*, 8 Sydney Law School Research Paper 64, p. 175 (2008).
10. For example, Lamensch refers to the "destination rule". *See* M. Lamensch, *European Value Added Tax in the Digital Era: A Critical Analysis and Proposals for Reform*, p. 2 (IBFD 2015), Books IBFD.
11. Millar compares the source/residence taxation of income with the origin/destination taxation in VAT. *See* R. Millar, *Echoes of Source and Residence in VAT Jurisdictional Rules*, 9 Sydney Law School Research Paper 44 (2009).

OECD documents the destination principle emerged for the first time only in 2004, where it was referred to as "an internationally accepted principle" according to which goods are zero rated at export and are taxed at import.[12] The OECD also pointed out that the principle is less clear in relation to services and intangibles.[13] As regards the origin principle, its meaning is even more unclear.[14] Being a counter-principle to the destination principle, the origin principle presupposes taxation of exports while exempting imports resulting in taxing the value added in a particular jurisdiction. However, in the EU VAT system the meaning of the origin principle is completely different: it basically refers to the equal treatment of domestic and cross-border supplies of goods and services.

The absence of a common understanding of the origin and destination principles results in confusion. It is a problem that different constructions of the aforementioned principles result in different legal outcomes. For example, taxation of services based on the destination principle could mean either (i) the application of VAT in the jurisdiction of the customer, (ii) taxation of services in the state of their final consumption, which is not necessarily the jurisdiction of the customer, or (iii) simply de-taxing[15] exported services. Another legal issue that arises is whether the destination principle has a coercive effect. Does the WTO compel its members to apply the destination principle or is its application a matter of choice made by states in furtherance of the intention to achieve neutrality of competition in international trade? Yet another issue is whether a consumption-type VAT may be based on the origin principle.

Particular considerations relate to the allocation of VAT in a tax union in respect of VAT, the theory of which justifies different treatment of consumption taking place within the tax union and outside its borders.[16] This book will argue that taking into account the existence of a tax union in respect of EU VAT, the allocation of VAT in the internal market[17] and in trade with

12. OECD, *The Application of Consumption Taxes to the Trade in International Services and Intangibles: Progress Report and Draft Principles* (OECD 2004).
13. For more details, *see* sec. 5.2.2.
14. *See*, for example, L. Ebrill et al., *The Modern VAT* p. 176 (International Monetary Fund 2001).
15. I.e. the application of a zero rate or exemption from VAT with the right to deduct, resulting in no VAT accruing in the jurisdiction of exportation.
16. For more details, *see* sec. 3.3.4.1.
17. Different terms may be found in the literature, in the ECJ's case law and in the documents of the Commission, namely, "internal market", "common market" and "single market". In the Treaty on European Union (2012) OJ C 326/13 (consolidated version) (hereinafter the TEU) and in the Treaty on the Functioning of the European Union (2012) OJ C 326/47 (consolidated version) (hereinafter the TFEU), the term "internal market"

third countries/territories does not necessarily have to be consistent. At the same time, the EU VAT system should be coherent when it comes to VAT allocation within the internal market. This book will illustrate that the hybrid character of the current EU VAT system,[18] along with different derogations still available for the Member States, make it an extremely complex and fragmented system. Moreover, the proposed future EU VAT system also remains hybrid, i.e. it incorporates different approaches towards VAT allocation.

In addition to the legal issues outlined above, a number of other questions in the context of the EU VAT system arise, in particular, the meaning attributed to the origin and destination principles by the Court of Justice of the European Union (ECJ) in its case law. Can these principles be used as a legal basis for determining a taxing jurisdiction in the European Union? Why, although having mentioned the destination principle in a few cases in relation to goods, has the ECJ never referred to it in relation to supplies of services? Could this imply that the destination principle is only relevant for supplies of goods?

The objective of this study is to contribute to the existing knowledge of the origin and destination principles. The results thereof should also be of use to the EU legislature for the purposes of establishing a coherent future EU VAT system, compatible with the requirements of the internal market.

## 1.2. Purpose of the study

The first purpose of this study is to establish what the content and function (legal status) of the origin and destination principles are, and to consider whether these two principles have the same meaning in the WTO legal order, the OECD framework and the EU legal order, which have been selected for the purpose of the analysis (hereinafter Purpose 1). The main legal questions that need to be answered to achieve Purpose 1 are as follows:

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is used. In this book the term "common market" is used when referring to the period prior to the adoption of the Single European Act, which introduced the internal market policy, and the term "internal market" is used for the period thereafter, unless a different terminology is adopted in the sources cited. In the latter case the original terminology will be kept. For an analysis of the different terminology *see* R. de la Feria, *The EU VAT System and the Internal Market* pp. 28-35 (IBFD 2009), Books IBFD.

18. I.e. combining features of origin-based and destination-based taxation.

(1) Do different conceptions exist of the origin and destination principles in the chosen international legal frameworks? Are they used consistently within each framework?

(2) Do the origin and destination principles have a coercive effect in the WTO and EU legal orders, and in the OECD framework? In particular:

- Does WTO law impose any limitations on the application of the origin and destination principles?

- Does the EU legal order consider the origin and destination principles as full-fledged principles of law?

Upon answering the legal questions provided above, conclusions will be drawn about what the origin principle and the destination principles intrinsically mean.

The second purpose of this study (referred to as Purpose 2) is to analyse the EU VAT system in order to find out which approaches towards allocation of VAT are reflected in the current legal provisions governing the application of VAT in cross-border trade within the European Union, as well as in cross-border trade with third countries and territories. Another objective is to analyse the proposals of the Commission and the legislative acts adopted by the Council in the course of the reform of the EU VAT system from the perspective of the origin and destination principles.

The OECD is of the opinion that the legal character of VAT as a tax on consumption requires the application of destination-based taxation.[19] The author will question this proposition, and illustrate that, subject to certain preconditions, origin-based taxation is also compatible with the legal character of VAT as a tax on consumption, in particular when it comes to the allocation of VAT in a tax union. Therefore, the third purpose of this study (referred to as Purpose 3) is to evaluate the origin and destination principles in the light of the legal character of VAT and the requirements of the internal market as defined in article 26 of the TFEU.

19. OECD Committee on Fiscal Affairs, Working Party No. 9 on Consumption Taxes, *OECD International VAT/GST Guidelines: Guidelines on Neutrality* para. 5 (OECD 2011), Primary Sources IBFD.

## 1.3. State of research

The origin and destination principles are widely referred to by scholars who write about problems related to the cross-border application of VAT.[20] An insight into these principles in terms of the general philosophy of taxation has been provided by Clara Sullivan.[21] Sullivan, does not, however, conduct a complex legal analysis, and limits her study to the European Economic Community.

A comprehensive analysis of the place-of-supply rules in European VAT has already been carried out by Ben Terra.[22] The primary focus of Terra's book on this subject is on the place of taxable transactions (including the historical perspective) and on relevant ECJ case law with the aim of clarifying the rules. This study analyses the EU place-of-supply provisions from a different perspective, that is, it reflects on the underlying approaches towards VAT allocation in those provisions.

Problems related to the application of VAT in the field of e-commerce have been addressed by many scholars including (i) Marie Lamensch,[23] who carried out an assessment of the EU VAT treatment of electronically supplied services and its compliance with the OECD recommendations and the principle of non-discrimination, (ii) Pernilla Rendahl,[24] who has undertaken a comparative analysis of the EU VAT, Australian goods and services tax (GST) and Canadian GST from the perspective of VAT treatment of cross-border business-to-consumer digital supplies and (iii) others.[25] The present study touches upon cross-border treatment of e-commerce in the European Union exclusively from the perspective of the alternative approaches towards VAT allocation studied herein and does not contain any comprehensive analysis of the relevant rules and problematics.

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20. *See*, for example, R. Millar (2009); Schenk, Thuronyi & Cui; B. Terra, *The Place of Supply in European VAT* (Kluwer Law International 1998); B. Westberg, *Nordisk Mervärdesskatterätt – Behandlingen av Utländska Företag, Varor eller Tjänster inom Ramen för Nationella Lagar* (Juristförlaget 1994).
21. Sullivan (1963).
22. Terra (1998).
23. Lamensch (2015).
24. P. Rendahl, *Cross-Border Consumption Taxation of Digital Supplies* (IBFD 2009), Books IBFD.
25. *See*, for example, J. Kollman, *Taxable Supplies and Their Consideration in European VAT – With Selected Examples of the Digital Economy* (IBFD 2019), Books IBFD; C. Herbain, *EU policy forum: Fighting VAT Fraud and Enhancing VAT Collection in a Digitalized Environment*, 46 Intertax 6/7 (2018), p. 579; A.M. Bal, *VAT Treatment of Initial Coin Offerings*, 29 Intl. VAT Monitor 3 (2018), Journal Articles & Papers IBFD.

The common market principle, which is discussed in this book, has been suggested by Dieter Biehl as the solution for an economic union.[26] This study is built upon Biehl's understanding of the common market principle, and illustrates how it is reflected in the current provisions of the EU VAT system. This book also argues that the common market principle, although origin-based, is compatible with the legal character of VAT as a tax on consumption.

A complex general analysis of tax issues covered by WTO law with the purpose of defining the WTO's role in regulating tax matters has been carried out by Jennifer Farrell.[27] The author builds on Farrell's analysis of the WTO system's tax provisions, limiting them to the application of indirect taxes to cross-border trade of goods and services, which is crystallized in the conclusions on the reflection of the destination and origin principles in the WTO legal order.

The origin principle and the destination principle have been extensively written about by Rebecca Millar, who discusses different proxies for determining the place of consumption, comparing the place-of-taxation rules in New Zealand with those of the European Union.[28] The present study complements that discussion by analysing the destination and origin principles in the EU VAT system, as well as from the perspective of the WTO legal order and the OECD framework.

A VAT/GST Model Convention as a solution for the prevention of double taxation/non-taxation in the field of VAT/GST has been suggested by Thomas Ecker.[29] The primary focus of the present book is intra-EU trade, which is not covered in Ecker's book. The author of this book believes that the issue of double taxation/non-taxation within the European Union is tackled by harmonization of the legal rules dealing with the imposition of turnover taxes and, in particular, by the existence of common provisions

26. D. Biehl, *Ausfuhrland-Prinzip, Einfuhrland-Prinzip und Gemeinsamer-Markt-Prinzip: Ein Beitrag zur Theorie der Steuerharmonisierung*, Schriftenreihe Annales Universitatis Saraviensis, vol. 30 (Carl Heymanns Verlag KG 1969). The author of this book adheres to the term "common market principle" further throughout this book.
27. J.E. Farrell, *The Interface of International Trade Law and Taxation* (IBFD 2013), Books IBFD.
28. Millar, *Jurisdictional Reach of VAT*; Millar, *Echoes of Source and Residence in VAT Jurisdictional Rules*; R. Millar, *Intentional and Unintentional Double Non-Taxation Issues in VAT*, 9 Sydney Law School Legal Studies Research Paper 45 (2009); R. Millar, *The Destination Principle: Past Developments and Future Challenges*, 12 Sydney Law School Research Paper 33 (2012).
29. T. Ecker, *A VAT/GST Model Convention: Tax Treaties as Solution for Value Added Tax and Goods and Services Tax Double Taxation* (IBFD 2013), Books IBFD.

for the allocation of taxing rights within the internal market of the European Union. Another means of tackling this issue has been the purposive interpretation of the current provisions of the VAT Directive by the ECJ in order to avoid conflicts of jurisdiction.[30] Moreover, the issue of double taxation in the field of VAT/GST in international trade is dealt with by the OECD, which has developed standardized proxies for determining the place of supply in the international trade of services and intangibles.

So far, no comprehensive legal analysis of the origin and destination principles has been carried out in academia. The objective of this study is to fill this gap and to contribute to a better understanding of these principles by carrying out a complex legal analysis thereof in the three international legal frameworks, that is, the WTO and the EU legal orders and the OECD framework.

## 1.4. Methodology and the book's outline

The legal dogmatic method as the traditional method of jurisprudence is the main method used for the purposes of this study. The author also used the comparative legal method as inspiration for the analysis of the international legal frameworks studied herein. The legal sources have been analysed from a historical perspective in order to better understand the content of the current provisions.

Chapter 1 contains an explanation of the term "principle" and a brief overview of the legal principles of EU law. This is needed to emphasize the distinction between legal principles, on the one hand, and the origin and destination principles, on the other. The latter, although referred to as "principles", do not constitute legal principles, as will be concluded in chapter 7 of this book.

The basic VAT features are outlined in chapter 2. This is important for the further evaluation of the origin and destination principles, which is carried out in chapter 7. Chapter 2 also lists the requirements imposed by the internal market in relation to the imposition of VAT in cross-border trade within the European Union.

30. The criterion of the rational result for tax purposes and/or preventing a conflict with another Member State is discussed in sec. 6.4.3.

Chapter 3 sets the scene for further analysis of the origin and destination principles. In particular, it touches upon the basis for fiscal jurisdiction of states and limitations thereon, as well as upon the peculiarities of fiscal jurisdiction concerning consumption tax. Furthermore, chapter 3 provides a brief overview of the different principles mentioned in the context of VAT and the rationale for choosing the origin and destination principles for the purposes of the analysis. These principles, which are two alternative approaches towards allocation of VAT, are introduced in chapter 3 based on how they are presented in the literature. Chapter 3 also contains an overview of economic literature regarding the origin and destination principles.

Chapter 4 is devoted to an analysis of the origin principle. The discussion starts by clarifying the concept of "origin" in international trade and customs law. The rationale for this is to illustrate that the meaning of the place of origin as perceived in WTO law and customs law is distinct from the meaning of "origin" in EU VAT law. Later, the origin principle is analysed in the legal contexts of the WTO legal order, the OECD framework and the EU legal order. The analysis related to the EU legal order encompasses an overview of economic studies for the establishment of the common market, the establishment of the definitive VAT system for taxation of cross-border supplies of goods and services (the historical perspective) and reflections on the origin principle in the legal provisions in force and its interpretation by the ECJ.

The analysis of the destination principle provided in chapter 5 follows a structure similar to that of chapter 4, subject to a few exceptions. It may be noted that the analysis of the destination principle in the WTO legal order is more extensive compared to the analysis of the origin principle in the same context. This may be explained by the presence of more legal materials in respect of the former. Additionally, chapter 5 includes an analysis of the principle of taxation at the place of consumption – which, in the author's view, is a genuine legal principle in the EU VAT system – and the effective use and enjoyment provisions.

Chapter 6 is dedicated to the application of VAT in the EU VAT system. A detailed explanation of the structure of chapter 6 is given in section 6.1.1. The chapter starts with an outline of the territorial scope of application of EU VAT, followed by an explanation of the concepts of "business establishment" and "fixed establishment" in view of their importance for the allocation of VAT. The further analysis is divided into the application of VAT (i) within the internal market and (ii) in trade with third countries and territories. The end of the chapter provides a critical analysis of the

proposals presented by the Commission for the future VAT system, as well as legislative acts adopted by the Council in the course of the EU VAT system's reform.

Finally, a summary of the findings of the previous chapters and an evaluation of origin-based and destination-based taxation are presented in chapter 7.

## 1.5. International legal frameworks

### 1.5.1. Introduction

The choice of international legal frameworks for the purposes of this study is not incidental. The destination principle is considered to be authorized by the WTO. For example, the OECD calls it the "international norm" and indicates that it is "sanctioned" by WTO rules.[31] However, it is not clear whether international recognition is intended or indeed whether the destination principle may be considered as binding under WTO rules. Furthermore, it is presumably in the context of the WTO legal order that the destination principle has received its international recognition. Moreover, the European Union is a WTO member in its own right, and, as such, should follow the rules of the WTO. In view of this, if any restrictions exist in relation to the application of the aforementioned alternative approaches towards VAT allocation in the international trade of goods and services imposed by WTO law, they shall be binding on the European Union.

The origin and destination approaches towards VAT allocation are also discussed by the OECD in the context of its work related to the establishment of international standards for the application of VAT/GST in international transactions with a focus on services and intangibles.[32] In particular, the OECD suggests the application of the destination principle as a global standard for internationally traded services and intangibles.[33] Therefore, this study uses the OECD framework for the purposes of the analysis.

As the EU VAT system is at the centre of this book, the EU legal order has been selected as the third international legal framework for the purposes of the analysis. Another consideration for choosing the EU legal order is the unique character of the European Union as a tax union in respect of indirect

31. OECD, *International VAT/GST Guidelines*, para. 1.11.
32. OECD, *International VAT/GST Guidelines*.
33. OECD, *International VAT/GST Guidelines*, para. 3.1.

**Notes**

**Contact**

IBFD Head Office
Rietlandpark 301
1019 DW Amsterdam
P.O. Box 20237
1000 HE Amsterdam
The Netherlands

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