



Marie Lamensch

European Value Added Tax in the Digital Era

A Critical Analysis and
Proposals for Reform

IBFD DOCTORAL SERIES

36

European Value Added Tax in the Digital Era

**Winner of the 2015 Maurice Lauré Prize awarded by
the International Fiscal Association (IFA).**

Why this book?

The Internet allows for instantaneous delivery of online supplies to consumers all over the world at any time of day or night. While the resulting “digital economy” offers great opportunities to suppliers and consumers, it also raises unprecedented challenges in the collection of value added taxes, particularly because of the intangible nature of online supplies, the relative anonymity of Internet users and the borderless nature of the e-marketplace.

This book assesses the practical feasibility of existing EU VAT provisions on “electronically supplied services” and tests their compliance with the widely acknowledged OECD “Ottawa Taxation Framework” and the constitutional principle of non-discrimination as embedded in international and European economic law. It reveals major flaws in EU VAT legislation and the underlying OECD benchmark, given that both assume that online suppliers are able to carry out transaction-based verifications of the status and location of their customers in the same way as traditional suppliers.

After discussing possible sources of inspiration for reforming the EU VAT treatment of online supplies (including the OECD “International VAT/GST Guidelines”, the 2014 BEPS report on the “Challenges of the Digital Economy” and the recent European Commission Communication on a Digital Single Market Strategy for Europe), innovative and practical proposals are made on possible technology-based mechanisms that could be used in the future for the correct assessment and collection of value added tax on online supplies.

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Setting the Scene

1.1. Research objective and outline

While originally developed as a means of communication between universities, the Internet rapidly turned into a broadly used medium that greatly facilitated international trade by allowing for the commercialization of traditional goods and services without the need for trading parties to meet at a certain location.¹ It further supported the creation of new types of products that are supplied “online” to customers on an “e-marketplace” that is constrained neither by geographic distances or borders nor by time, because it allows for instantaneous delivery without transport delays or supply chain formalities and is always open for business. While these “online supplies” offer many advantages, they also pose unprecedented legal challenges because regulatory systems are traditionally applied to physically identifiable subjects and products, and linked to the (geographically limited) national jurisdiction of the enacting states. These systems thus do not easily cope with the global and decentralized nature of an e-marketplace that is not constrained by place and time and that combines the intangibility of online supplies with the relative anonymity of Internet users.²

In the field of taxation,³ one of the challenges is that traditional value added tax (or “VAT”) systems were developed when supplies of goods constituted

1. For a history of the Internet, see R. Zakon, *Hobbes' Internet Timeline* (RFC Ed. 1997) and C. Gringras, *The Laws of the Internet* (Tottel Publishing 2008).

2. E.g. see D.R. Johnson & D. Post, *Law and Borders: The Rise of Law in Cyberspace*, 48 Stan. L. Rev. 1367 (1996); D.G. Post, *Anarchy, State, and the Internet: An Essay on Law-Making in Cyberspace*, available at <http://www.temple.edu/lawschool/dpost/Anarchy.html> (1996); J. Rosenoer, *Cyberlaw: The Law of the Internet* (Springer 1997); L. Lessig, *Code and Other Laws of Cyberspace* (Basic Books 1999); L. Lessig, *The Place of Cyberlaw in The Place of Law*, A. Sarat ed. (University of Michigan Press 2003); C. Gringras, *The Laws of the Internet* (Tottel Publishing 2008); D. Svanteson, *Private International Law and the Internet* (Kluwer 2012). See also the 1997 G7 Ministerial Declaration on e-commerce and the 1997 EU-US Joint declaration on e-commerce.

3. For a discussion of the tax aspects of e-commerce, see contributions listed in the Bibliography by: Jenkins; Terra & Bulk; Grierson; McLure; Dittmar & Selling; Hinnekens; Lambert; Doernberg & Hinnekens; Kortenaar & Spanjersberg; Dressler, Goulder & Bick; Goolsbee; Cockfield; Hellerstein & McLure; Jones & Basu; Westberg; Hellerstein; Svantesson; Rendhal; Cockfield et al.; and Lamensch.

the bulk of international trade. For that reason, they were designed on the basis of the “tangible” nature and assumed “physical” move of the taxable base across borders from a known point or origin to a readily identifiable destination. Online supplies, however, flow from one location to another in an instantaneous and mostly anonymous way, irrespective of the location of the parties to the transaction, without regard for distance and jurisdiction, and unhindered by transport constraints or supply chain formalities. Moreover, online supplies blur the traditional distinction between where they should be taxed or as regards the applicable rates and exemptions. As a consequence, traditional VAT rules prove – by design – difficult to apply to online supplies, which creates major challenges for tax assessment and collection, a situation that has been complicated by the fact that international coordination of tax jurisdiction has traditionally focused on income taxes rather than on consumption taxes.

In 1998, OECD ministers meeting in Ottawa endorsed a report of the Committee on Fiscal Affairs (CFA) entitled *Electronic Commerce: Taxation Framework Conditions* (hereinafter “the Ottawa Framework”).⁴ This report is the outcome of discussions between tax authorities of OECD members and representatives of the business community.⁵ Two sets of implementing guidelines for the Ottawa Framework were released in 2001 and 2003 by the OECD Working Party 9 (WP9).⁶ Also in 2003, the CFA released a Report on Automating Consumption Tax Collection Mechanisms.⁷ Finally, the OECD Centre for Tax Policy and Administration (CTPA) published some further guidelines, notably three papers that form part of a Consumption Tax Guidance Series.⁸ The Ottawa Framework and subsequent

4. OECD, *Electronic Commerce: Taxation Framework Conditions*, A Report by the OECD Committee on Fiscal Affairs, as presented to Ministers at the OECD Ministerial Conference “A Borderless World: Realising the Potential of Electronic Commerce” on 8 October 1998 (hereinafter “the Ottawa Framework”).

5. See OECD, *Joint Declaration of Business and Government Representatives: Government/Business Dialogue on Taxation and Electronic Commerce* (7 Oct. 1998).

6. OECD, *Consumption Tax Aspects of Electronic Commerce*, A Report from Working Party No. 9 on Consumption Taxes to the Committee on Fiscal Affairs (Feb. 2001) (hereinafter the “OECD WP9 2001 Report”) and OECD, *Implementation of the Ottawa Taxation Framework Conditions*, The 2003 Report (hereinafter the “OECD WP9 2003 report”).

7. OECD, *Automating Consumption Tax Collection Mechanisms*, DAF/FE/CFA(2003)43/ANN5 (2003).

8. The Consumption Tax Guidance Series includes three documents: OECD, *Electronic Commerce – Commentary on the Place of Consumption for Business to Business Supplies (Business presence)* (2003); OECD, *Electronic Commerce – Simplified Registration Guidance* (2003) and OECD, *Verification of Customer Status and Jurisdiction* (2003). See also OECD, *Facilitating Collection of Consumption taxes on Business-to-Consumer Cross-Border E-commerce* (2003).

implementing guidelines (hereinafter together referred to as “the OECD recommendations”) became an international standard for the taxation of online supplies.

The European Union (EU) implemented the OECD recommendations in its harmonized VAT system⁹ by means of a Directive on, inter alia, “certain electronically supplied services”, effective since 1 July 2003.¹⁰ Several pieces of implementing legislation were adopted throughout the years, some of which only entered into force on 1 January 2015¹¹ (hereinafter the “specific EU VAT provisions for electronically supplied services”).

In parallel, the EU is mobilizing substantial resources for the completion of a “Digital Single Market” by 2020. This ambitious goal so far resulted in the adoption of the “Digital Agenda”¹² and of the “Single Market Act”.¹³ In 2011, the European Commission also released its Communication, *A coherent framework to build trust in the Digital Single Market for e-commerce and online services*,¹⁴ which sets out the Commission’s vision as regards the potential contribution by electronically supplied services to growth and employment, identifies the main obstacles to the development

9. Based on Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ 11 December 2006 L347/1, and implementing and amending acts (hereinafter the “VAT Directive”).

10. Council Directive 2002/38/EC of 7 May 2002 amending and amending temporarily Directive 77/388/EEC as regards the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services, OJ L128, 15.5.2002, pp. 41-44.

11. Including Council Regulation 1777/2005/EC of 17 October 2005 laying down implementing measures for Council Directive 77/388/EEC on the common system of value added tax, OJ L288/1, 29/10/2005, Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services, OJ 20 Feb. 2008, L44/11, Council Regulation 282/2011 of 15 March 2011 laying down implementing measures for Directive 2006/112/EC on the common system of value added tax, OJ 23 Mar. 2011, L77/1, Council Regulation 967/2012 of 9 October 2012 amending Implementing Regulation (EU) No 282/2011 as regards the special schemes for non-established taxable persons supplying telecommunications services, broadcasting services or electronic services to non-taxable persons, OJ 20 Oct. 2012, L290/1 and Council Regulation 1042/2013 of 7 October 2013 amending Implementing Regulation (EU) No 282/2011 as regards the place of supply of services, OJ 26 Oct. 2013, L284/1.

12. See the European Commission website dedicated to the Digital Agenda: <http://ec.europa.eu/digital-agenda/>.

13. See the European Commission website dedicated to the Single Market Act: http://ec.europa.eu/internal_market/smact/.

14. European Commission, *A coherent framework for building trust in the Digital Single Market for e-commerce and online services* (Communication to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions), COM(2011) 942 final.

of e-commerce and electronically supplied services, and establishes priorities, accompanied by an action plan. In May 2015, the Commission released yet another communication on A Digital Single Market Strategy for Europe, with a roadmap for the years 2015 and 2016.¹⁵ Surprisingly, even though tax-related issues are regularly mentioned as a potential source of concern for achieving the Digital Single Market, no analytical work has so far been done to assess the exact tax practicalities involved and no amendment of the existing VAT provisions applying to electronically supplied services seems to be on the agenda for the completion of the Digital Single Market.

Against this background, the objective of this research is to assess the practical feasibility of the specific EU VAT provisions for electronically supplied services and their compliance with the widely acknowledged OECD recommendations that they are meant to implement. In addition, the research also seeks to test these provisions against the principle of non-discrimination that is embedded in international and European economic law. Finally, wherever this research identifies flaws in the existing provisions, it seeks to explore possible solutions and makes practical proposals on possible ways forward to remedy these flaws.

For that purpose, the remainder of this chapter provides a more general background on VAT as a consumption tax, on the EU VAT harmonization process and on the phenomenon and definition of e-commerce and online supplies, while also exploring the difficulties and options for them in terms of taxation. Section 1.2. introduces readers to the concept of consumption taxes and the main characteristics of the value added tax as a broad-based, multistage, non-cumulative consumption tax of the destination type, which, even though regressive, is relatively efficient in that it does not create disincentives to economic growth. It then provides a rapid overview of the VAT harmonization process on which the EU Member States have embarked since the late 1960s. Section 1.3. defines online supplies as supplies that are ordered *and* delivered through the Internet and, after sketching their economic importance, focuses on the main challenges which online supplies pose to regulatory and tax systems, essentially because they are not bound to place and time, allow the parties to remain anonymous and are transmitted in different electronic packages. After discussing more particularly the challenges of applying value added taxes to online supplies, different pos-

15. European 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*, SWD(2015) 100 final.

sible approaches to e-commerce taxation are discussed (exemption from VAT, BIT tax, application of traditional rules as adapted). Section 1.4. then summarizes the widely acknowledged OECD recommendations.

Chapter 2 analyses the five sets of EU VAT provisions that specifically apply to electronically supplied services and which concern respectively: (i) the categorization and definition of electronically supplied services; (ii) the place of supply; (iii) related collection mechanisms; (iv) the non-applicability of reduced rates and (v) the allocation of tax liability for supplies made through intermediaries (such as marketplaces for applications and similar forums). For each of these sets of provisions, the research summarizes the difficulties that arise in a digital context, describes the applicable EU VAT provisions meant to address these difficulties and critically assesses these provisions, focusing, first, on the practicalities of their implementation and, second, on their compliance with the OECD recommendations on which they were modelled.

Chapter 3 subsequently tests the specific EU VAT provisions for electronically supplied services against the principle of non-discrimination. In the context of this assessment, we will refer to the principle of neutrality as defined in the Ottawa Framework and the case law of the Court of Justice of the European Union (CJEU), as well as the EU and WTO provisions on the prohibition of discrimination.

Chapter 4 first briefly summarizes the solutions, if any, found in selected third countries (the United States, Australia, New Zealand, Canada, Norway, Singapore and South Africa) to the challenges involved in applying consumption tax rules to online supplies and it also discusses the current OECD work on services and intangibles (which, however, now tends to address e-commerce in a broader and less specific context). Based on the analysis in chapters 2 and 3 and, where relevant, also on the lessons learnt in other consumption tax systems and within the OECD, tentative proposals for reform are formulated in the second part of chapter 4 that concern the qualification of online supplies under the EU VAT system, the proxies that could be relied on to implement the applicable place of supply rules and the way tax assessment and collection could be organized for these supplies. Two concrete and technology-based suggestions are set out, which should allow for an automated assessment and collection of VAT on online supplies that has the promise of increasing the revenue intake without increasing the compliance costs for the private sector or the administrative burden for the tax authorities.

A summary of the main findings and conclusions will be offered in chapter 5.

1.2. Consumption taxes and VAT

1.2.1. Taxation – Definition and traditional distinctions

Taxation can be defined in different ways, but it essentially comprises any compulsory transfer of financial resources from the private to the public sector without the taxpayer receiving any specific benefit in return or as counterpart.¹⁶ Generating revenue is arguably the core objective of any tax¹⁷ and in many countries taxes are the primary source of government revenue.¹⁸ Taxes are in principle not earmarked,¹⁹ but they allow for the financing of a variety of policies and public services such as internal and external security, justice, health care, education and public transport.²⁰

Traditionally, a distinction has been made between “direct” and “indirect” taxes. Schenk and Oldman define indirect taxes as those levied upon commodities before they reach the consumer who ultimately pays the tax as part of the market price, while direct taxes are those that are directly assessed upon the property, business or income of the taxpayer.²¹ Another

16. S. van Thiel, *The removal of indirect tax obstacles to intra-Community trade and unfinished business in the VAT area*, in *VAT harmonization in the EU and unfinished business*, S. van Thiel ed. (CFE 2008), p. 3. The absence of counterpart distinguishes taxes from fees and charges (e.g. see S. Cnossen & C.S. Shoup, *Coordination of value-added taxes*, in *Tax Coordination in the European Community*, S. Cnossen ed. (Kluwer 1987), p.71).

17. Taxation may have additional goals than generating revenue such as the macroeconomic objectives of full employment or price stability (see J. Due, *Sales Taxation* (Routledge and Kegan Paul 1957), p. 42; A. Lerner, *Economics of Employment* (McGraw-Hill 1951), p. 131), the redistribution of income (see C. Alley & D. Bentley, *A Remodelling of Adam Smith's Tax Design Principles*, Australian Tax Forum (2005/20), p. 584; J. Due, id., p. 36) and to discourage certain behaviour (e.g. taxes on alcohol or tobacco) or have an “environmental” objective (see R. Bird & O. Oldman, *Taxing in Developing Countries*, p. 343 (John Hopkins University Press 1990, 4th edn)).

18. According to Eurostat, tax revenue in the EU-27 accounted for about 90% of total government revenue in 2011 (Eurostat, *Tax Revenue Statistics*, data December 2012).

19. K. Holmes, *The Concept of Income: A multi-disciplinary analysis* (IBFD Doctoral Series 2000), p. 3; see also C. Alley & D. Bentley, *A Remodelling of Adam Smith's Tax Design Principles*, Australian Tax Forum (2005/20), p. 583.

20. Lauré defines taxation (*fiscalité*) as “des prélèvements imposés aux habitants d'un pays par une autorité qui, de son côté, assure la protection et fournit des services” (M. Lauré, *Science Fiscale* (PUF 1993), p. 13). See also M. Duverger, *Finances Publiques* (PUF 1978), p. 123.

21. A. Schenk & O. Oldman, *Value Added Tax: A Comparative Approach* (Cambridge Tax Law Series 2007), p. 5 with reference to Walker. In the same sense, see F. Lefebvre (Mémento expert Francis Lefebvre, TVA 2012-2013) and Van Brederode (R. Van Brederode, *Sales Taxation* (Kluwer 2009), p. 25).

common way to distinguish between the two categories is related to the question whether the person who actually pays the tax to the authorities suffers a corresponding reduction of his income.²²

Even though the distinction between indirect and direct taxes is not theoretically perfect in an economic sense,²³ it is a traditional working distinction in international economic law.²⁴ In the World Trade Organization (WTO), for instance, although neither the General Agreement on Tariffs and Trade (GATT) nor the General Agreement on Trade in Services (GATS) give a definition of “direct” as opposed to “indirect” taxes,²⁵ the international agreement on the distinction appears in footnote 58 to the 1995 Agreement on Subsidies and Countervailing Measures (“SCM Agreement”) which lists “direct taxes” and “indirect taxes”, as follows:²⁶ Direct taxes include: “taxes on wages, profits, interest, rents, royalties and all other forms of income, and taxes on the ownership of real property”,²⁷ and indirect taxes include: “sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all other taxes than direct

22. Schenk & Oldman, id., p. 5. In the same sense, see J. Englisch, *VAT/GST and Direct Taxes: Different Purposes*, in *Value Added Tax and Direct Taxation: Similarities and Differences* (IBFD 2009), p. 1.

23. These distinctions are indeed based on the assumption that indirect taxes are paid by consumers while economists have long indicated that, depending on market conditions and price elasticity of demand, wholesalers or retailers may not always be able to fully shift the tax burden to consumers, whereas corporate income taxes are at least partially shifted forwards into prices. See R. Goode, *The Corporation Income Tax* (Wiley 1951), ch. 4; R.A. Musgrave, *The Shifting of the Corporate Income Tax* (John Hopkins University Press 1963).

24. S. van Thiel, *The removal of indirect tax obstacles to intra-Community trade and unfinished business in the VAT area*, in *VAT harmonization in the EU and unfinished business*, S. van Thiel ed. (CFE 2008), p. 7.

25. In fact, the term “tax” is used 106 times in the GATT, the GATS and the Agreement on Subsidies and Countervailing Measures (“SCM Agreement”) but is never defined, even though the GATT refers to several types of taxes such as “customs duties” and “charges of any kind” (art. I GATT – Most Favoured Nation Treatment), “internal taxes” and “other internal charges” (art. III GATT – National Treatment on International Taxation and Regulation), which are not defined in the GATT itself but in the WTO Dictionary of Trade Policy Terms. J. Farrell, *The Interface of International Trade Law and Taxation* (IBFD Doctoral Series 2013), pp. 42-44.

26. Article XVI of the GATT together with the SCM Agreement prohibits member countries from providing export subsidies. Annex I to the SCM Agreement contains an illustrative list of export subsidies. Footnote 58 to the agreement subsequently clarifies the terms “direct taxes” and “indirect taxes” by means of examples.

27. Article XXVIII(o) of the GATS also defines “direct taxes” but in a different way than the SCM Agreement. The GATS does not contain any definition of indirect taxes. J. Farrell, *The Interface of International Trade Law and Taxation* (IBFD Doctoral Series 2013), p. 46.

taxes and import charges”.²⁸ “Prior-stage indirect taxes” are “those levied on goods and services used directly or indirectly in making the product”.²⁹

The EU Treaty on the Functioning of the European Union (“TFEU”)³⁰ neither lists nor defines direct versus indirect taxes, but it nevertheless refers to indirect taxes in article 110 as “internal taxes” imposed “on the products of other Member States”, and in articles 112 and 113 by using the negative formula: “charges other than turnover taxes, excise duties and other forms of indirect taxation”, thereby implicitly recognizing the traditional distinction made between direct and indirect taxes.³¹

Indirect taxes thus include all taxes that are imposed on the supplies of goods and services, and there are various ways to distinguish between different types of indirect taxes. One way is to look at the coverage of the tax (or the tax base) and a traditional distinction is made between broad-based taxes, such as VAT, which are in principle imposed on all supplies, and narrow-based taxes, such as excise duties, which are imposed only on targeted supplies.³² A second distinction is made between indirect taxes that are single staged and in most cases imposed only on the final stage of the supply chain, i.e. the final supply to the consumer, and indirect taxes that are multi-staged, i.e. imposed on each transaction in the supply chain, irrespective of whether the supply is between taxable persons (e.g. from producer to wholesaler and on to the retailer) or to the final consumer.³³ In the case of multi-staged taxes, a third distinction is made between cumulative taxes, which

28. There seems to be an implicit assumption that the GATT only applies to indirect taxation, even if there is not explicit exclusion of direct taxes. Farrell, id., p. 46. See, however, S. van Thiel, *General report on the July 2005 Rust Conference on the WTO and taxation*, in *WTO and Direct Taxation*, *Schriftenreihe zum internationalen Steuerrecht* 35/2005, M. Lang et al. eds. (Linde Verlag 2005), at 21-25.

29. This categorization shows that the WTO follows the traditional approach to tax incidence according to which all direct taxes are presumed to be borne by businesses and all indirect taxes by final consumers (R. Van Brederode, *Sales Taxation* (Kluwer 2009), p. 210).

30. The TFEU was first published in the OJ of 17 December 2007 (C-306) and entered into force on 1 December 2009, following ratification of the *Treaty of Lisbon*.

31. Articles 110-112 of the TFEU essentially provide that border tax adjustments are allowed in the case of indirect taxes to the extent they are not excessive (articles 110 and 111 of the TFEU) but not in the case of direct taxes. Article 113, which calls upon the Council to harmonize indirect taxes, uses the same wording as article 112 of the TFEU.

32. E.g. see J. Due, *Sales Taxation* (Routledge and Kegan Paul 1957), p. 3; R. Van Brederode, *Sales Taxation* (Kluwer 2009), p. 27; S. Cnossen, *Three VAT studies* (CPB Netherlands Bureau for Economic Policy Analysis 2010), p. 18 (available on the CPB website).

33. E.g. see Due, id., p. 3; A. Schenk & O. Oldman, *Value Added Tax: A Comparative Approach* (Cambridge Tax Law Series 2007), p. 33; Van Brederode, id., p. 12.

include tax paid in previous stages in the tax base for subsequent stages, and non-cumulative taxes, which are imposed strictly on the increase in the value of the product and not also on the tax component that accumulates in previous stages.³⁴ Finally, in cross-border trade a distinction is traditionally made between origin-based taxes, which are imposed on domestic supplies and exports, but not on imports, and destination-based taxes, which are imposed on domestic supplies and exports, but not on imports.³⁵

On the basis of the above distinctions, most “value added taxes” imposed in the world can be defined as broad-based, multistage, non-cumulative consumption taxes of the destination type.³⁶ These characteristics will be further described in the next sections, after a brief introduction on the origin and spread of the VAT system.

1.2.2. Origin and spread of VAT

VAT has a long history and has been conquering the world particularly in the last 30 years. Von Siemens first proposed the concept of a VAT tax in 1919.³⁷ In 1921, Adams developed the “credit invoice method” to prevent tax cumulation in view of a potential implementation in the United States, which, however, never materialized.³⁸ France was eventually the first country to introduce a VAT in 1954,³⁹ based on the proposal of Lauré, then joint director of the French tax authority.⁴⁰

34. E.g. see Due, id., p. 4; Van Brederode, id., p. 17.

35. E.g. see L. Ebrill et al., *The Modern VAT* (IMF 2001), ch. 17; A. Schenk & O. Oldman, *Value Added Tax: A Comparative Approach* (Cambridge Tax Law Series 2007), p. 188.

36. OECD, *International VAT/GST Guidelines on Neutrality, approved by the Committee on Fiscal Affairs on 28 June 2011* (2011), p. 3.

37. C.F. von Siemens, *Veredelte Umasatzsteuer* (Siemenstadt 1919).

38. T.S. Adams, *Fundamental Problems of Federal Income Taxation*, 35 *Quarterly Journal of Economics*, p. 527 (1921).

39. Introduced by Act n° 54-404 of 10 April 1954. *Journal Officiel* of 11 April 1954 and *Rectificatif Journal Officiel* of 20 May 1954. At the time, the introduction of VAT was seen as “an invention of the first order” and France as an “innovator in taxation”. See C.S. Shoup, *Taxation in France*, 8(4) *Natl. Tax J.*, pp. 325-344 (1955). However, value added taxes had been enacted in 1953 in Michigan, US (see Lock, Rau & Hamilton (1955); J. Due, *Sales Taxation* (Routledge and Kegan Paul 1957), p. 138 and J.A. Papke, *Michigan’s Value-Added Tax After Seven Years*, 13(4) *Natl. Tax J.*, pp. 350-364 (1960)) and in 1950 in Japan (see M. Bronfenbrenner, *The Japanese Value-Added Sales Tax*, 3(4) *National Tax Journal* (1950), pp. 298-314; Due, id., p. 142 and A. Schenk, *Japanese Consumption Tax: The Japanese Brand*, 42 *Tax Notes* 1625 (1989)).

40. M. Lauré, *La Taxe sur la valeur Ajoutée* (Sirey 1952). See also M. Lauré, *Au secours de la TVA* (PUF 1957); and more recently M. Lauré, *Science Fiscale* (PUF 1993),

Among the several ways to tax the value of goods and services consumed by taxpayers, value added taxes have gained a leader position because they appear to be the least distorting taxes (*see* section 1.2.4.), which, despite some problems, can be administered effectively in most countries.⁴¹ Their neutrality also ensured their success against customs duties in the context of trade liberalization.⁴² Unsurprisingly, therefore, the International Monetary Fund and the World Bank usually expect from developing countries to which they are lending funds that they start levying value added taxes as part of the reform of their tax system.⁴³

By any standards, the rise of the VAT system has been a most significant development in tax policy and administration in recent decades.⁴⁴ Limited to less than 10 countries in the late 1960s, value added taxes are now levied in more than 150 countries. In fact, with the exception of the United States,⁴⁵ all OECD members have a VAT.⁴⁶ While first introduced some 60 years ago, value added taxes currently affect about 4 billion people and are used in both developing and developed countries at local, national and supranational levels of government.⁴⁷

in particular, ch. XXX (*La petite histoire de la TVA*) retracing the historical context and legislative process.

41. S. Cnossen, *VAT Coordination in Common Markets and Federations, Lessons from the European Experience*, 63 *Tax L. Rev.*, p. 583 (2009-2010). *See also* R. Bird, *Value Added Tax and Excises: Commentary*, prepared for the *Report of a Commission on Reforming the Tax System for the 21st Century* (2008), p. 1.

42. OECD, *Draft International VAT/GST Guidelines* (2006 draft).

43. A. Schenk & O. Oldman, *Value Added Tax: A Comparative Approach* (Cambridge Tax Law Series 2007), p. 18.

44. M. Keen & B. Lockwood, *The Value-Added Tax: Its Causes and Consequences*, IMF WP/07/183 (2007), p. 3; *See also* R. Bird, *Value Added Tax and Excises: Commentary*, Prepared for the *Report of a Commission on Reforming the Tax System for the 21st Century* (2008), p. 1; *See* R. Millar, *The Impact of GST and VAT on Cross-Border Transactions*, presented at the conference *Commercial Practice in a Global Economy*, organized jointly by the Commercial Law Association of Australia and the Ross Parsons Centre of Corporate, Commercial and Taxation Law, University of Sydney, 1 August 2008, p. 1.

45. Many proposals have been made to introduce a federal VAT in the US, either to replace or to supplement the federal income tax. *See* R. Van Brederode, *Sales Taxation* (Kluwer 2009), p. 102 and the references made to the numerous legislative proposals and discussion of the different methods discussed.

46. S. Cnossen, *Three VAT studies* (CPB Netherlands Bureau for Economic Policy Analysis 2010), p. 17 (available on the CPB website); *See also* OECD, *Consumption Tax trends 2008, VAT/GST and excise rates, trends and administrative issues*, p. 23 (2008).

47. M. Keen & B. Lockwood, *The Value-Added Tax: Its Causes and Consequences*, IMF WP/07/183 (2007), p. 3.

The global spread of VAT typically occurred in regional bursts.⁴⁸ Reasons underlying the adoption of a VAT system vary. Developing countries, for instance, have used it as a way to raise additional revenue or because of the pressure of businesses and international organizations to modernize their tax system.⁴⁹ In the EU, the adoption and further harmonization of a common system of VAT is mostly due to the historical objective of promoting full economic integration between the Member States by achieving, initially, a “Common Market” and, since 1993, an “Internal Market” without (internal) frontiers. In addition, because the EU budget since the 1970s is financed entirely on the basis of “own resources” that are partly financed out of Member States’ VAT revenues,⁵⁰ the adoption of a harmonized VAT system in all Member States also became necessary to ensure Member States’ equal budgetary contribution.

1.2.3. VAT as an indirect tax on consumption expenditure collected by taxable persons

In general, value added taxes are considered to be consumption taxes that are collected by taxable persons on a transaction basis, i.e. upon the supply of goods and services, which is also why, as noted already, they are, without exception, classified as indirect taxes.

The particularity of value added taxes is that they are strictly speaking not imposed on the addition of value to products and services by taxable persons, but on the consumption, or rather acquisition, of the products and services by the end consumer.⁵¹ Since taxes on consumption generally refer to taxes on the acquisition of goods and services by individuals for their personal use or satisfaction,⁵² the question has been raised whether con-

48. Id., p. 18.

49. A. Schenk & O. Oldman, *Value Added Tax: A Comparative Approach* (Cambridge Tax Law Series 2007), p. 17. See also L. Ebrill et al., *The Modern VAT* (IMF 2001), p. 6.

50. Council Decision of 21 April 1970 on the Replacement of Financial Contributions from Member States by the Communities’ own Resources (70/243 ECSC, EEC, Euratom), OJ 28.04.1970, L94, p. 19 (so-called “own resources decision”). The contribution is calculated by applying a flat rate (fluctuating from 1% to 1.4%) to an assessment basis that is capped at 50% of a Member State’s GDP.

51. L. Ebrill et al., *The Modern VAT* (IMF 2001), p. 1.

52. A. Schenk & O. Oldman, *Value Added Tax: A Comparative Approach* (Cambridge Tax Law Series 2007), p. 1.

sumption taxes should not instead be defined as “taxes on expenditures”.⁵³ It is true that “consumption” is a rather undefined concept and that in most cases the supplier will have no idea of when and where the actual consumption or use of his products or services takes place.⁵⁴ Moreover, it is never the effective “use” of a product that is taxed. If the buyer of a product does not eventually use it, the tax can indeed not be recovered on the grounds that the product or service was not actually used.⁵⁵ Furthermore, the only (taxable) event that generally can be located in place and time is where and when the transaction between the supplier and the buyer took place.⁵⁶ Finally, consumption can only be taxed if we can express its value in monetary units, which can probably be usefully established only at the moment of acquisition. As summarized by Van Brederode: “The monetary value of consumption finds embodiment in the expenditure made to purchase it”.⁵⁷ Therefore, it is probably more correct to refer to “taxes on consumption expenditures” rather than to “consumption taxes”, but in the context of this study, the question is little more than a semantic one and the term “consumption tax” is traditionally used in the literature.

In practice, a value added tax is thus collected by the supplier in the framework of a taxable transaction (the “taxable person”) and paid by the customer or consumer (the “taxpayer”) as a part of the sales price. Suppliers, in their capacity as taxable persons, must assess, on a transaction basis, the amount of tax due in accordance with the applicable rules (i.e. base, exemptions, rates or any special regime) and remit that amount to the tax administration in the jurisdiction having taxing rights over the transaction. Suppliers bear the costs related to these collection or “compliance” obligations and are liable for the correct payment of the tax, although they do not

53. Kaldor proposed a direct tax on consumption that could be paid directly by consumers to the government (N. Kaldor, *An Expenditure Tax* (George Allen and Unwin 1955)). Van Brederode notes that in practice, “direct consumption taxes” are seldom used (R. Van Brederode, *Sales Taxation* (Kluwer 2009), p. 26).

54. R. Millar, *Jurisdictional Reach of VAT*, Sydney Law School Legal Studies Research Paper no. 08/64, eventually published in *VAT in Africa*, R. Krever ed. (2008).

55. This is the only practicable approach because the person liable for collecting the tax (the supplier) cannot be required to modify the amount of tax paid after the purchase because the recipient did not use the supply at the expected place.

56. Millar and Cnossen therefore insist on the “transactional basis of consumption taxes”, that should rather be envisaged as a tax on expenditure at the time and place where it is incurred, R. Millar, *Jurisdictional Reach of VAT*, Sydney Law School Legal Studies Research Paper no. 08/64, eventually published in *VAT in Africa*, R. Krever ed. (2008), and reference to Cnossen.

57. R. Van Brederode, *Normative evaluation of consumption tax design: The treatment of the sales of goods under VAT in the European Union and Sales Tax in the United States*, Tax Lawyer 2009, 1055.

receive any payment for that activity. This is why they often see themselves as “unpaid tax collectors”.⁵⁸ In some cases of business-to-business (“B2B”) supplies, the collection obligations may be shifted from the supplier to the (business) taxpayer who will then be liable for correctly self-assessing the tax due and remitting it to the competent tax administration on a voluntary basis (also known as “reverse charging”).⁵⁹ Even in this case, however, suppliers remain responsible for verifying that self-assessment/reverse charging rules apply, before making a (tax-free) supply (on which the tax will subsequently be paid by the business customer, on his initiative).

The fact that the supplier collects the tax and that the tax may increase the sales price raises the question of the incidence of the tax, or, in other words, the question whether the supplier will actually be able to fully shift the tax burden forwards to the consumer. As noted already, consumption taxes are designed on the assumption that the tax is fully shifted to the final consumer, which is also the criterion that is traditionally used to characterize them as indirect taxes.⁶⁰ The question has been preoccupying economists for a long time⁶¹ and it is now generally accepted that the ability of the supplier to shift the tax burden forwards to consumers in the form of higher prices actually depends on his market position and on the price elasticity of demand,^{62,63} and that, to the extent the tax burden cannot be shifted by the supplier to the consumer, the value added tax in effect becomes a tax on production rather than on consumption.⁶⁴

58. PWC, *Tax policy and administration – Global perspectives, Shifting the balance from direct to indirect taxes: Bringing new challenges* (June 2013).

59. See A. Schenk & O. Oldman, *Value Added Tax: A Comparative Approach* (Cambridge Tax Law Series 2007), p. 93; B. Terra & J. Kajus, *A Guide to the European VAT Directives – Introduction to European VAT* (IBFD, selected edn 2009), p. 1017.

60. See section 1.2.1.

61. The question of who bears the burden of taxation has been preoccupying economists since the 19th century. E.g. see A. Marshall, *Principles of Economics*, 8th edn (1920), p. 343. Retrieved from *Library of Economics and Liberty* (<http://www.econlib.org/library/Marshall/marP.html>).

62. In practice, if demand for a product is inelastic, the burden of the tax can be forwarded to the consumer (R. Van Brederode, *Sales Taxation* (Kluwer 2009), p. 29 and ff.; L. Ebrill et al., *The Modern VAT* (IMF 2001), p. 15).

63. Van Brederode, id., p. 17, with reference to M. Rothbard, *Power and Market: Government and the Economy*, 2nd edn, pp. 88-93 (Sheed Andrews and Mc Neel 1977); H. Gunnison Brown, *The Incidence of General Sales Tax in Readings in the Economics of Taxation*, R. Musgrave & C. Shoup eds. (Homewood 1959), pp. 330-339 and M. Rothbard, *The Consumption Tax: A Critique*, Review of Austrian Economics 7, pp. 75-90 (1994). See also M. Lauré, *Au secours de la TVA* (PUF 1957), ch. V (*L'incidence de l'impôt*) and ch. VI (*La fiscalité et les prix des produits*).

64. Van Brederode, id., pp. 29-33; J. Farrell, *The Interface of International Trade Law and Taxation* (IBFD Doctoral Series 2013), p. 47.

1.2.4. VAT as a multistage, non-cumulative tax

As indicated above, consumption taxes can be imposed on a single stage in the chain of production and distribution to the consumer (single-staged tax) or on more, or all, stages (multistage tax). A value added tax is a multistage consumption tax that is imposed whenever products (legally) change hands, including on transactions between suppliers (such as the supply from the producer to the wholesaler or distributor and from the distributor to the retailer). In early forms of multistage consumption taxes, the tax imposed in the subsequent stages was imposed not only on the value of the product but also on the tax paid in the previous stages (a “tax on tax”).⁶⁵ Such “cascading” tax could not be reclaimed by the intermediate supplier and therefore became part of the sales price, so that the tax component of the end-price became larger, the more stages there were between the producer and the end consumer.⁶⁶ This resulted in potential distortions of competition and trade. On the one hand, since the end price was dependent on the number of intermediate stages in the supply chain between the producer and the end consumer, potential distortions of competition arose because vertically integrated cycles of production and distribution could offer lower end prices.⁶⁷ On the other hand, the cascading effect resulted in potential distortions of international trade in destination-based systems (i.e. taxation in the country of the customer, *see* section 1.2.6.) for the simple reason that neither the exact amount of tax nor the accompanying border tax adjustment could be ascertained upfront and with certainty as it depended on the number of stages the product and its inputs would go through.⁶⁸

In principle, value added taxes avoid the cascading effect by allowing taxable persons involved in the production, distribution and sale of a taxable supply to deduct their “input tax” (i.e. the tax that was invoiced to them and that they have paid in respect of the purchases and imports of goods and services used for the purpose of their undertakings) from their “output tax” (i.e. the tax which they collected on their sales), and obtain a refund of

65. Van Brederode, *id.*, p. 17. E.g. the German *Umsatzsteuer*, introduced in 1934. For a critical analysis, *see* J. Due, *Sales Taxation* (Routledge and Kegan Paul 1957), p. 53.

66. J. Owens, *The move to VAT*, Intertax 1996/2, p. 45 (1996); Van Brederode, *id.*, p. 17.

67. J. Due, *Sales Taxation* (Routledge and Kegan Paul 1957), p. 22; Van Brederode, *id.* pp. 18 et seq. and 60. *See also* M. Lauré, *Science Fiscale* (PUF 1993), p. 229.

68. S. van Thiel, *Harmonisation of Turnover Taxes in the European Communities: Towards the Internal Market without frontiers*, EC, March 1988, p. 77; R. Van Brederode, *Sales Taxation* (Kluwer 2009), p. 18 and *id.*, *Normative evaluation of consumption tax design: The treatment of the sales of goods under VAT in the European Union and Sales Tax in the United States*, Tax Lawyer 2009, p. 1055.

the excess of input over output tax.⁶⁹ Accordingly, although a value added tax is levied on each transaction, only the final supply from the retailer to the end consumer is subject to a net tax, which allows preserving production efficiency.⁷⁰ Value added taxes are thus multistage, non-cumulative consumption taxes.

The difference in the method of collection (i.e. in full from retailers under single-staged forms and fractionally throughout the production and distribution process under multistage forms) should in principle not affect the tax revenue yield⁷¹ and both single- and multistage taxes should be collectable roughly at the same time.⁷² But interestingly, the fractioned collection of the tax in multistage systems is thought to yield more revenue because it has an impact on the enforcement of the tax. As a matter of fact, in single-staged taxes, tax liability is concentrated at the retail stage, whereas in the VAT system, tax liability is spread over all economic transactions, so that the amount at risk of tax fraud is smaller in case of non-compliance. In addition, multistage taxes are thought to have a “self-enforcing effect” because a refund of input tax is only available if the taxable person provides evidence of VAT paid by means of an invoice.⁷³ There are nuances to this view, however. The self-enforcing effect should probably not be overestimated, because it depends on administrative, including audit, efficiency (under a single-staged system, tax authorities can concentrate their efforts on one stage).⁷⁴ In addition, revenue leaks also occur in multistage systems, for instance, because the credit mechanism gives rise to fraud, mainly related to the possibility to deduct input VAT and obtain refunds.⁷⁵ Finally,

69. In the EU VAT system, this objective is achieved through the credit-invoice method, but it can also be achieved by other methods such as the credit subtraction method (not relying on invoices), the sales-subtraction method and the addition method. A. Schenk & O. Oldman, *Value Added Tax: A Comparative Approach* (Cambridge Tax Law Series 2007), p. 41 and ff.; R. Van Brederode, *Sales Taxation* (Kluwer 2009), p. 20.

70. L. Ebrill et al., *The Modern VAT* (IMF 2001), p. 15.

71. R. Van Brederode, *Sales Taxation* (Kluwer 2009), p. 13.

72. S. Cnossen, *VAT and RST: A comparison*, 35 Canadian Tax Journal 3, p. 559 (1987).

73. E.g. see R. Bird & O. Oldman, *Taxing in Developing Countries*, p. 368 (John Hopkins University Press 1990, 4th edn); S. Cnossen, *VAT Coordination in Common Markets and Federations, Lessons from the European Experience*, 63 Tax L. Rev. 583 (2009-2010), pp. 12 and 13; R. Van Brederode, *Sales Taxation* (Kluwer 2009), p. 109.

74. Van Brederode, id., p. 108. It is nevertheless commonly acknowledged that even poorly administered multistage systems produce more revenue as compared to single-stage taxes.

75. A “simple” type of fraud consists in making false VAT claims (based on counterfeited invoices). A much more sophisticated type of fraud consists in registering for VAT, buying goods VAT free from another Member State, selling them on at VAT

a major drawback of multistage systems as compared to single-staged systems is that they impose non-negligible compliance burdens and costs on the supply side, related to filing and reporting requirements and refund procedures, which may also negatively affect the net revenue.⁷⁶

1.2.5. VAT as a broad-based tax

Value added taxes are traditionally broad based, i.e. levied on a wide range of supplies, in contrast to narrow-based consumption taxes such as excise taxes, customs duties and certain special taxes, which are levied on the supply of a selection of goods.⁷⁷ A (broad-based) VAT may in principle apply to all supplies (e.g. EU VAT system applies in principle to all supplies of goods and services) or to certain types of supply (e.g. US sales and use taxes apply to tangible property in general and certain services and intangibles, *see* chapter 4).

In general, a broad-based tax is more equitable because it affects all consumers and products in the same way. It also allows for a lower tax rate in order to generate a satisfactory level of revenue,⁷⁸ which is positive because it is widely acknowledged that the higher the tax rate, the higher the incentive to avoid or escape the tax (which actually proves easier in case of a narrow-defined tax base because it is possible to turn to untaxed products, which is less the case when the tax base is defined in broader terms).⁷⁹ Broad-based value added taxes therefore have the advantage of generating significant amounts of revenue⁸⁰ while interfering as little as possible with

inclusive prices and then disappearing without paying the VAT due (i.e. the so-called “carousel fraud”). S. Cnossen, *VAT Coordination in Common Markets and Federations, Lessons from the European Experience*, 63 Tax L. Rev. 583 (2009-2010), pp. 12 and 13. *See also* M. Keen, *VAT attacks*, IMF Working Paper WP/07/142 (2007), p. 15; R. Van Brederode, *Sales Taxation* (Kluwer 2009), p. 251.

76. R. Bird & O. Oldman, *Taxing in Developing Countries*, p. 367 (John Hopkins University Press 1990, 4th edn). *See also* Van Brederode, *id.*, pp. 111 and 116; L. Ebrill *et al.*, *The Modern VAT* (IMF 2001), p. 52.

77. Narrow-based consumption taxes may be useful, for example, to discourage certain behaviour (e.g. the (excessive) use of tobacco, alcohol or gasoline) and achieve other national policy objectives. Bird & Oldman, *id.*, p. 343.

78. J. Due, *Sales Taxation* (Routledge and Kegan Paul 1957), p. 30.

79. World Bank, *Lessons of Tax Reform*, note 2 at 16.

80. E.g. EU Member States collect substantial VAT revenues thanks to a broad tax base and relatively high average rates (more than 3.5 times higher than sales and use taxes collection in the US). *See* S. Cnossen, *VAT Coordination in Common Markets and Federations, Lessons from the European Experience*, 63 Tax L. Rev. 583, pp. 12 and 13 (2009-2010).

economic behaviour and avoiding inequitable consequences on consumers depending on their consumption needs.⁸¹

In practice, however, even the broadest-based consumption tax system provides for exemptions, an exempt supply being a non-taxable supply that does not entitle to a refund of input tax (unlike a zero-rated supply, *see below*). The traditional reasons to apply exemptions are of a social, economic and administrative nature. First, exemptions can be used for social reasons, i.e. to allow for broad access to the consumption of certain essential goods or services (e.g. hospital and medical care, children's education). Second, exemptions can be used to encourage the consumption of "merit" goods and services (e.g. of an educational or cultural nature). Third, certain supplies may be exempt for administrative reasons, for instance, under the "difficult to tax" argument (e.g. financial services, for which it is often difficult to identify the tax base)⁸² or to avoid excessive tax collection and compliance costs (e.g. small and medium size enterprises).⁸³

Because an exempt supply does not entitle to a refund of input tax, exemptions cause a "cascading effect" in non-cumulative multistage taxes that objectively break the principle that tax paid by taxable persons can be recovered up to the retail stage. This may result in input choice distortions because suppliers and producers may be encouraged to rely on self-supplies (vertical integration).⁸⁴ For those sectors in which vertical integration is not possible, the use of exempt supplies results in a clear disadvantage for suppliers because they will not be able to offset the input VAT they have incurred on upstream transactions. This may actually result in suppliers including the cost of unrecoverable input tax in the sales price. In case of numerous intermediate transactions, each potentially bearing a cost of unrecoverable input tax, this could result in substantially higher end prices for consumers.⁸⁵ In view of the direct and significant consequence of

81. J. Due, *Sales Taxation* (Routledge and Kegan Paul 1957), p. 41.

82. E.g. financial services are traditionally exempt because of the difficulty to separate the subject of the transaction and the income it generates and the related judicial and accounting complexities (A. Kerrigan, *The Elusiveness of Neutrality – Why Is It So Difficult To Apply VAT to Financial Services?*, Intl. VAT Monitor (March/April 2010), p. 103, Journals IBFD; Covas Carvalho et al., *The VAT exemption for insurance-related services of brokers and agents: The case of a "call center"*, 51 Eur. Taxn. 1, p. 19 (2011); *See also* R. Van Brederode, *Sales Taxation* (Kluwer 2009), pp. 138-164.

83. Van Brederode, *id.*, p. 123. In this case, the exemption thus applies to a "person" rather than to a type of supply.

84. L. Ebrill et al., *The Modern VAT* (IMF 2001), p. 87. *See also* Van Brederode, *id.*, p. 128.

85. A. Schenk, *Value Added Tax: A Model Statute and Commentary: A Report of the Committee on Value Added Tax of the American Bar Association Section of Taxation*

exemptions (no deduction of input VAT), rules related to exemptions are, unsurprisingly, a major source for legal dispute.⁸⁶

1.2.6. VAT and cross-border transactions: Origin versus destination

Value added taxes are internal taxes⁸⁷ that in theory could be imposed only on domestic supplies, but that are in practice always imposed on both domestic supplies and cross-border supplies.⁸⁸ In practice, the tax must be levied in the jurisdiction where the supply is deemed to take place. In the case of a cross-border supply, this can be either “at origin”, i.e. in the jurisdiction of the supplier, or “at destination”, i.e. in the jurisdiction of the customer.⁸⁹ An origin-based tax is therefore levied on domestic supplies and exports, while a destination-based tax is levied on domestic supplies and imports. The choice of a jurisdiction rule (“place of supply rule” in EU language, *see* chapter 2) bears significant economic and political consequences, as it determines which jurisdiction will benefit from the tax revenue and which jurisdiction has taxing rights over which consumers.

From a practical perspective, the origin principle presents major advantages because suppliers are able to collect tax on all their supplies in accordance with the same (home or origin state) tax rules and there is no need for border tax adjustments (*see* below).⁹⁰ This substantially reduces

(American Bar Association 1989), pp. 62-64; Van Brederode, id., p. 32. J. Englisch, *The EU perspective on VAT exemptions*, in *EUCOTAX Series on European Taxation VAT Exemptions Consequences and Design Alternatives*, R. de la Feria ed. (Kluwer 2013), p. 38. *See also* M. Lauré, *Science Fiscale* (PUF 1993), ch. XXVII (*La TVA n'est pas un impôt séable*).

86. Englisch, id.

87. The concept of “internal” taxation is used in article III of the GATT (“National Treatment on Internal Taxation and Regulation”) and in article 110 of the TFEU, both of which provide that internal taxes should not be imposed in a discriminatory or protective way on imports.

88. The reason is that no state would choose to impose a higher tax on domestic products than on imports. On the other hand, a value added tax could not apply only to imports because it would lose its quality of internal tax and effectively become a customs duty.

89. R. Van Brederode, *Sales Taxation* (Kluwer 2009), p. 205.

90. In fact, it is not essential that tax administrations keep account of the exports and imports under an origin system, but it is essential that the full value of exported goods bears domestic tax and that a full credit be granted for the value of imports. A. Schenk & O. Oldman, *Value Added Tax: A Comparative Approach* (Cambridge Tax Law Series 2007), p. 183; Van Brederode, id., p. 205; L. Ebrill et al., *The Modern VAT* (IMF 2001), p. 183.

compliance burdens and costs, with the caveat, however, that taxable persons would need to obtain refunds of input tax in the jurisdictions of their respective suppliers. From a states' viewpoint, an origin-based tax also reduces opportunities for fraud.

However, the origin principle is hardly ever used as a jurisdiction rule for international trade because it carries risks of competition distortion, as purchasing decisions of end consumers and taxable persons may be influenced by tax considerations.⁹¹ As a matter of fact, end consumers may prefer to purchase items from a production jurisdiction with a lower consumption tax rate, which leads to competition distortions, particularly in border areas.⁹² Moreover, purchasing decisions of taxable persons may also be distorted in an origin-based system in case tax refunds in the jurisdiction of origin are not available or only partially available. And, in fact, even when full refunds are available, the relative importance of tax rate differences, combined with the time it takes to receive the refunds, might be taken into account by businesses for cash flow reasons, which may also lead to distorted purchase decisions.

In addition, from a revenue and an interstate equity viewpoint, it is traditionally acknowledged that an origin system adversely affects the revenue position of net importers, so that a switch from a destination to an origin system requires compensation mechanisms in order to ensure that the tax ultimately benefits the tax jurisdiction where the supply was used. With such an adequate compensation mechanism, the origin principle would therefore allow for taxation at origin while ultimately implementing a destination-based distribution of revenue (in the sense that the jurisdiction that is entitled to the tax revenue is the jurisdiction of import and consumption). But this is where the shoe pinches, because none of the systems proposed in the literature (including "export rating" proposed by Cnossen,⁹³

91. J. Mirrlees, *Tax by Design*, in *The Mirrlees Review* (Oxford University Press 2011), p. 184; Van Brederode, id., p. 205; Tuan Minh Le T. M. Le, *Value-added-taxation: Mechanism, Design, and Policy Issues*, Paper prepared for the World Bank course on Practical Issues of Tax Policy in Developing Countries (Washington DC, 28 April-1 May 2003), p. 21; J.E.S. Oliveira, *Economic Effects of Origin and Destination principle for Value-Added Taxes*, School of Business and Public Management, George Washington University (2001); OECD, *International VAT/GST Guidelines on Neutrality*, approved by the Committee on Fiscal Affairs on 28 June 2011, at 5 (2011).

92. W. McNie, *The Origin Principle and Transport Costs*, in *Fiscal Harmonization in Common Markets*, Vol. II, C. Shoup ed., (Columbia University Press 1967), p. 21; R. Van Brederode, *Sales Taxation* (Kluwer 2009), p. 231.

93. "Export rating" (origin taxation with a clearing system) was proposed by Cnossen in 1983 (S. Cnossen, *Is the VAT's Sixth Directive Becoming an Anachronism?*, 43 Eur. Taxn. 12 (2003), p. 434) and proposed by the European Commission in 1985

the VIVAT system proposed by Keen and Smith,⁹⁴ the CVAT suggested by Varsano and McLure,⁹⁵ or the dual rate system proposed by Bird and Gendron)⁹⁶ ever satisfied governments, who continue to fear that taxation systems with an element of origin taxation carry the risk of not seeing all tax revenue accrue to the country of import.

Finally, origin-based taxation may also create an incentive for businesses to use non-arm's length transfer prices for their intermediate transactions with a view to having the bulk of value added taxed in low-rate jurisdictions.⁹⁷ As transfer pricing has been a major problem in income taxes for decades, it is worth avoiding it, where possible, for consumption taxes.

(European Commission, *Completing the Internal Market, White Paper from the Commission to the European Council*, COM(85) 310 final (1985)), but it failed to convince Member States and literature (see C. Lee, M. Pearson & S. Smith, *Fiscal Harmonisation: An analysis of the Commission's Proposals*, (IFS Report Series 28, 1988)).

94. In 1996, Keen and Smith proposed the VIVAT system (viable integrated VAT). Under this imaginative scheme, each Member State would levy a VIVAT at an EU-wide uniform rate for all B2B supplies, regardless of the location of the customer, and VAT at a rate of its own choosing on other domestic sales (including sales to unregistered traders). Input tax would be creditable and VAT would only be borne by the final consumers. Again, a clearing arrangement would redistribute revenue collected to the jurisdiction of destination. (M. Keen & S. Smith, *The Future of Value Added Tax in the European Union*, in *Economic Policy*, (Oxford University Press 1996), p. 375 and M. Keen & S. Smith, *Viva VIVconAT!*, 7 *International Tax and Public Finance* 6, p. 741 (2000)).

95. Under the CVAT, first conceived by Varsano and subsequently elaborated by McLure, each state would tax B2B and B2C domestic supplies at a VAT rate of its choosing, while collecting a uniform rate "compensating VAT" on exports (R. Varsano, *Subnational Taxation and the Treatment of Interstate Trade in Brazil: Problems and a Proposed Solution*, in *Decentralization and Accountability of the Public Sector*, S.J. Burki & G.E. Perry eds., *Proceedings of the World Bank Annual Conference on Development in Latin America and the Caribbean* (1999), p. 339; C. McLure, *Implementing Subnational VATs on International Trade: The Compensating VAT (CVAT)*, 7 *International Tax and Public Finance* 6, p. 723 (2000); B. Genser, *Coordinating VATs Between EU Member States*, 10 *International Tax and Public Finance* (2003), p. 735).

96. Bird and Gendron proposed a dual rate regime under which the national systems (zero rating of intra-Community exports) would apply in parallel with a new "EU VAT", set at a uniform rate. This new tax would generate revenue for the Community and ensure that intra-Community supplies, although zero-rated, at exports are eventually taxed. See R. Bird & P-P. Gendron, *Dual VATs and Cross-Border Trade: A Review of International Experience*, Discussion Paper No. 13, International Centre for Tax

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