

Cross-Border Consumption Taxation of Digital Supplies

Sample excerpt

Abstract

Consumption taxes such as value added tax (VAT) or goods and services tax (GST) are an important revenue source for several countries, not least within the European Union (EU) which has had a harmonized VAT since the end of the 1960s. The intention of consumption taxation is to tax expenditures made by persons for their private purposes, i.e. the tax burden is carried by the final consumer.

In the middle of the 20th century, the Internet opened up the possibility for electronic commerce. Many problems arise when the rapid evolution of techniques related to e-commerce is mixed with the objective of consumption taxation, particularly in cross-border supplies to consumers. This study focuses on the cross-border consumption taxation on digital supplies in business to consumer e-commerce from an international coordination perspective.

The study presented in this book covers a comparative study of EC VAT, Australian GST and Canadian GST concerning how digital supplies are taxed in business to consumer cross-border supplies. It particularly focuses on potential risks of double taxation and unintentional non-taxation and identifying the causes for such cases. In addition the possible remedies suggested by the Organization for Economic Co-operation and Development (OECD) for double taxation and unintentional non-taxation are discussed. The findings in the study are evaluated based on rationality, which refers to the consumption taxation upholding the principles that are part of the OECD, Ottawa Taxation Framework Conditions. The principles that are part of the Framework Conditions are; neutrality, efficiency, certainty and simplicity, effectiveness and fairness and flexibility. The evaluation shows that the principle parts of the evaluation model are difficult to reach at a unilateral level, further international coordination is therefore necessary. Further international coordination should mean that principles need to be agreed upon at three levels:

- a policy level (so that jurisdictions effectively agree upon where supplies should be taxed),
- a legislative level (so that the policies and principles are effectively transformed into legislation that can be applied by tax authorities and courts, and
- an interpretative level (so that tax authorities and courts do not alter the intended policies and principles through diverging methods of interpretation).

Part II: Classification & Place of Supply

Chapter 5: Classification of Digital Supplies

5.1. The problems concerning classification

This chapter deals with the classification of digital supplies. The classification is evaluated by drawing up the framework for these supplies within EC VAT, Australian GST and Canadian GST. This chapter thereby correlates to the first research question of the aim for this study.¹

Uncertainty in the classification of supplies causes difficulties for the supplying companies in B2C transactions. It is likely to increase the administrative burden for the companies and may also have economic effects for them, affecting the pricing and costs of the supplies since different rates apply depending on how the classification is made. It is thereby also the starting point for where the supplies are deemed to be made i.e. which state that has a right to tax the supply. The Ottawa Taxation Framework Conditions (the Framework Conditions) agreed upon by the Member States of the OECD, forms the base for the evaluation model as discussed in chapter 3. The Framework Conditions suggests that digital supplies should be taxed at the place of consumption.²

The different classifications for supplies are often found in rules that are decisive for where the supply is taxed – rules concerning the place of supply. Therefore arguments for why a supply is classified a certain way often depend on where these supplies are suitable to tax. This chapter deals primarily with the classification as such, whereas the following chapter, chapter 6 deals with the place of supply and the consequences these rules may have for digital supplies.

From a state perspective it is a question of balancing the need for tax revenue from these supplies against administrative costs for enforcing applicable rules and potential risks for tax evasion. Which then are the different criteria you need to be aware of in order to foresee the VAT consequences for different digital supplies?

Case law from the ECJ, the Australian courts and Canadian courts is analyzed to give guidance on how digital supplies are or might be treated. The cases that are brought up are chosen to highlight important aspects of the framework for digital supplies. They are also chosen in accordance with the stipulated prerequisites in section 2.4.2. These prerequisites cover four different issues where the first is whether the case illustrates differences or similarities between different classifications. Secondly, whether parallels can be drawn from the case to digital supplies, even if the case as such does not directly concern such supplies. Thirdly, if principles can be ascertained from the courts' reasoning which also can assist in classifying digital supplies. Fourthly, whether it is possible to formulate criteria that certain types of supply need to fulfil to follow a particular classification, which also are valid for digital supplies.

Where case law is rare regarding the issue particularly discussed, the point of view of the tax authorities is brought up showing the administrative practice. This is especially valid for

808. The first research question is: how are digital supplies classified for consumption tax purposes, see section 1.2.

809. See section 3.7.1.

Australian and Canadian GST. Few cases deal specifically with the issues of classification of supplies covered in this study.

The EC VAT rules will differ during a transitional period due to the acceptance of the VAT package³ and directive 2008/8/EC⁴. Consequently the analysis in this chapter of EC VAT is carried out by following the structure of the rules valid until 2010 and the changes following directive 2008/8/EC are treated in connection to the types of supplies concerned. Most of the changes affect the rules concerning the place of supply, but not the classification issues as such.

This chapter brings up the three different jurisdictions separately to give a better overview of the different types of supplies. The comparison between the jurisdictions is generally carried out consecutively throughout the chapter and particularly in the end of the chapter.

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Chapter 6: Deciding the Place of Supply

6.1. Principles governing the place of supply

This chapter evaluates the place of supply for digital supplies in EC VAT, Canadian GST and Australian GST. It thereby serves two purposes where the first is to compare where digital supplies are taxed based on how they are classified in the three jurisdictions.⁵ The second purpose is to identify if there are risks for double taxation and unintentional non-taxation because of the rules concerning the place of supply. Hence, this chapter aims at answering the second research question of the aim.⁶

The starting point for this analysis is the principles governing the place of supply, common for the EU, Canada and Australia although the terminology as such differs. The principles governing the place of supply are either related to the destination principle or the origin principle. Where the destination principle applies, the transaction is taxed where the transactions end, or as several jurisdictions put it, where the supply is consumed.⁷ The destination principle can also cover supplies that are effectively used and enjoyed within a country or state, but this terminology may also be used to override the destination principle if the supply is destined to a country or state, but effectively used or enjoyed in another.⁸ Such cases may exist where a consumer purchases a digital product while travelling, e.g. portable access to the Internet, but he or she usually resides in a different country. Thus, one must carefully consider if the destination principle is formulated as the place where the consumer usually resides, where the supply is effectively used or enjoyed, i.e. where the supply is consumed, or where the supply ends. These different criteria may lead to dif-

810. See The Council of the European Union, Outcome of proceedings, ECOFIN Council, 4 December 2007, Brussels, 5 December 2007 (16220/07).

811. Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services, OJ L 44, 20.2.2008.

1057. The classification of digital supplies is discussed in chapter 5.

1058. The second research question is *how is the place of supply decided for digital supplies and what consequences do these rules have for cross-border B2C supplies?*

1059. See e.g. The EC VAT directive, Art. 56 (1) and the Canadian ETA, section 142 (2) and the Australian GST Act 1999, section 85-1.

1060. See e.g. Australian GST Act 1999, section 85-1 and the EC VAT directive, Art. 58.

fering results even if a destination based argument is used for deciding the place of supply.

An origin based argument leads to the opposite result, thus a transaction is taxed where the supply begins or where the supplier has established her business or has a fixed establishment.⁹ In the Ottawa Taxation Framework Conditions, the OECD holds that digital supplies should be taxed at the place of consumption.¹⁰ This implies that states should opt for taxing digital supplies in accordance with a destination based principle. The *General Agreement on Tariffs and Trade (GATT)* holds that taxation should not be used as a means for discrimination between imported and domestic products.¹¹ This non-discrimination clause refers to products and goods. However, the *General Agreement on Trade in Services (GATS)* cover a most favoured nation clause and services should thereby not be treated in a discriminatory way.¹² The most favoured nation clause is held to be valid for supplies delivered by electronic means.¹³

Within the EU the matter of which principle best fulfils the goals of an efficient market has been discussed since the harmonization of the VAT began. The importance of abolishing tax barriers on importation and exportation between the Member States were part of the First VAT directive.¹⁴ There has also been an ongoing discussion on which principle best fulfils the goals of the internal market.¹⁵ The original objective that the place where the supplier is established best fulfils the goals of the internal market has changed since this opens up tax planning opportunities, where companies choose to establish their business where the most preferential rates apply; this especially relates to companies that supply digital supplies since they can be supplied from a distance.¹⁶ The VAT rates are not fully harmonized within the EU and the most neutral way to overcome this problem is to use a destination based approach.¹⁷ Neutrality in this sense is then related to fair competition at an intra-external level as referred to in section 3.3.4.¹⁸

In both Canada and Australia supplies are mostly discussed from the perspective of whether they are connected to, or carried out in the different jurisdictions. This reasoning is based on the destination principle and often connects to consumption in the sense that if the supply is effectively used or enjoyed in Canada or Australia, then it should be taxed

1061. See e.g. the EC VAT directive, Art. 43. The different principles deciding the place of supply have previously been discussed in literature. See e.g. Terra, Ben, J.M., "Avoidance of Double Taxation in VAT the Place of Supply in the EEC", 1 *International VAT Monitor* 4 (1990), pp. 9-11 and Ruppe, Hans Georg, "General Report" in *International problems in the field of general taxes on sales of goods and services*, Cahiers de droit fiscal international, Vol. LXVIIIb, (The Netherlands, Kluwer, 1983), pp. 116–120.

1062. See section 3.7 where this is discussed.

1063. See WTO, General Agreement on Tariffs and Trade 1947, Text of the General Agreement, Geneva, July 1986, Art. III.

1064. See WTO, General Agreement on Trade in Services, 1994, Art. II.

1065. See WTO, Work Programme on Electronic Commerce, Progress Report to the General Council, Adopted by the Council for Trade in Services on 19 July 1999, S/L/74, 27 July 1999, paras. 8 and 9.

1066. See First Council Directive 67/227/EEC of 11 April 1967 on the harmonization of legislation of Member States concerning turnover taxes, OJ 71, 14.4.1967, para. 4 in the preamble and Art. 1.

1067. See e.g. A Common System of VAT – A Programme for the Single Market, COM(96)328final, Brussels 22.07.1996 and Communication from the Commission to the Council and the European Parliament, A Strategy to Improve the Operation of the VAT System within the Context of the Internal Market, COM (2000)348 final, Brussels, 07.06.2000.

1068. See Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, Review and Update of VAT Strategy Priorities, COM(2003)614 final, Brussels 20.10.2003, p. 13.

1069. See Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, Review and Update of VAT Strategy Priorities, COM(2003)614 final, Brussels 20.10.2003, p. 13.

1070. This has also been referred to as an equality principle, see Terra, Ben, J.M., "Avoidance of Double Taxation in VAT the Place of Supply in the EEC", 1 *International VAT Monitor* 4 (1990), p. 9.

there.¹⁹ In all three jurisdictions the criteria used for deciding whether the supplier has a connection to the jurisdiction is the criteria of fixed establishment (EU) or permanent establishment (CAN, AUS). This is discussed further on in this chapter.

6.2. The EU

6.2.1. Telecommunication services

Telecommunication services in B2C commerce can be deemed to be supplied both in accordance with the principles of destination and origin. The applicable rules are outlined in Table 6-1, showing the differences depending on the establishment of the supplier and the customer.

From the 1st January 2010 the rules concerning the place of supply governing electronically supplied services are found in Art. 45, 58, and 59 of the VAT directive. The change from 2010 does not alter the place of supply and Table 6-3 is, thus, still valid. From 1 January 2015 the place of supply is going to be shifted from the origin principle to the destination principle for supplies from a supplier established in a Member State but not the one where the consumer is resident or usually resides.²⁰ An overview of the rules applicable from 1 January 2015 is given in Table 6-2, in section 6.2.1. Table 6-2 covers both electronically supplied services, telecommunication services and radio and television broadcasting services, since these supplies will be subject to the same provisions after 2015.

The main reason for shifting from the principle of origin to the principle of destination is to prevent suppliers from setting up establishments in other Member States with a lower VAT rate and using this as a competitive advantage.²¹ Since the present rules are considered not to uphold taxation at the place of consumption, they are regarded as insufficient by the Commission.²²

Part III: Evaluation & Conclusions

Chapter 7: Double Taxation and Unintentional Non-taxation

7.4. A rational consumption taxation of digital supplies?

7.4.1. Initial remarks

Rationality, as used in this study, refers to whether the consumption taxation upholds the principles that are part of the evaluation model.²³ Cases of double taxation and unintentional non-taxation are held not to be rational since they distort the fundamental principles of a value added tax.²⁴ In sections 7.2 and 7.3, above, different cases of double taxation and unintentional non-taxation have been related to the evaluation model and which types of distortions they may cause. Another important issue is to what degree the rationality is

1071. See e.g. the Australian GST Act 1999, section 9-25 and Canadian ETA, Part IX, section 142(1).

1085. See Council Directive 2008/8/EC, Art. 5 (1) and the changed Art. 58.

1086. See COM(2005) 334 final, Explanatory Memorandum p. 12.

1087. See COM(2005) 334 final, Explanatory Memorandum p. 12.

1374. See section 1.2.

1375. See section 6.5.

upheld in the current system. Hence, *if the legal framework leads to a rational consumption taxation of digital supplies*²⁵ is further evaluated using an evaluation model based on the OECD Framework Conditions.²⁶ This evaluation model forms the Spider's Web presented in Figure 3-4.²⁷

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7.4.3. Legal efficiency

Legal efficiency as used in this study refers to the complexity of the consumption tax provisions. More complex rules are held to increase the compliance costs for the company, but the compliance costs are also affected by steps taken to try to ease the burden for the companies.²⁸

Canadian GST, Australian GST and EC VAT have several different types of supplies that could be covered by digital supplies.²⁹ EC VAT has the largest scope of different types of supplies that affects digital supplies, whereas Canada has the narrowest. If the classification is compared to how the rules concerning the place of supply function, Australian GST is, however, even more simplistic, since it uses the same criteria for establishing the place of supply for all different *things*.³⁰ Hence, the scope of the types of supplies affecting digital supplies is also affected by which criteria that are used for deciding the place of supply.

In cross-border supplies it is not only the provisions in one of the jurisdictions that affect the legal efficiency, but provisions in two or more jurisdictions. Legal efficiency is thus also dependent on how the different provisions in the jurisdictions concerned correlate. Where there is double taxation the compliance costs, and probably also costs for carrying the burden of the consumption tax, distort legal efficiency.

Within EC VAT the changes adopted in a three-step phase through directive 2008/8/EC are accompanied by a procedure for simplification of where the suppliers need to register and submit the VAT returns – a one-stop-shop scheme.³¹ This scheme is important in trying to decrease the compliance costs for the supplying companies, especially considering that the rules concerning the place of supply generally are shifted from the origin principle to a destination principle for services that can be supplied from a distance.³² Even so, criteria used within the one-stop-scheme where tax authorities may *assume* that a taxable person has ceased its economic activity, need further clarifications. Which steps do the suppliers need to take to ensure that such an assumption does not occur?

1376. The third research question of the aim, see section 1.2.

1377. See sections 1.2 and 3.1.

1378. See section 3.8.

1389. See section 3.3.5.

1390. Compare Figure 5-3 in section 5.2.1, Figure 5-6 in section 5.3.1 and Figure 5-7 in section 5.4.1.

1391. See section 6.4.3.

1392. See section 6.2.5.

1393. See Table 6-2 in section 6.2 for an explanation of the destination principle's effects on telecommunication services, electronically supplied services and radio and television broadcasting services.