Chapter 1

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. 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.

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

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, Goold & 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 jurisdic-
tion, 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 interna-
tional 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 Com-
mittee on Fiscal Affairs (CFA) entitled Electronic Commerce: Taxation
Framework Conditions (hereinafter “the Ottawa Framework”). This report
is the outcome of discussions between tax authorities of OECD members
and representatives of the business community. Two sets of implementing
guidelines for the Ottawa Framework were released in 2001 and 2003 by
the OECD Working Party 9 (WP9). Also in 2003, the CFA released a
Report on Automating Consumption Tax Collection Mechanisms. Finally,
the OECD Centre for Tax Policy and Administration (CTPA) published
some further guidelines, notably three papers that form part of a Con-
sumption Tax Guidance Series. 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 Min-
   isterial 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:
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, DAFFE/
8. The Consumption Tax Guidance Series includes three documents: OECD, Elec-
   tronic Commerce – Commentary on the Place of Consumption for Business to Busi-
   ness Supplies (Business presence) (2003); OECD, Electronic Commerce – Simplifi-
   cation of Collection Guidance (2003) and OECD, Verification of Customer Status and Ju-
   risdiction (2003). See also OECD, Facilitating Collection of Consumption taxes on
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 system by means of a Directive on, inter alia, “certain electronically supplied services”, effective since 1 July 2003. Several pieces of implementing legislation were adopted throughout the years, some of which only entered into force on 1 January 2015 (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” and of the “Single Market Act”. 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, 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

---

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-

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. Generating revenue is arguably the core objective of any tax and in many countries taxes are the primary source of government revenue. Taxes are in principle not earmarked, 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.

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. 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, Tazing 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).


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.\textsuperscript{22}

Even though the distinction between indirect and direct taxes is not theoretically perfect in an economic sense,\textsuperscript{23} it is a traditional working distinction in international economic law.\textsuperscript{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,\textsuperscript{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:\textsuperscript{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”,\textsuperscript{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 taxes.”

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

\textsuperscript{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, \textit{The Corporation Income Tax} (Wiley 1951), ch. 4; R.A. Musgrave, \textit{The Shifting of the Corporate Income Tax} (John Hopkins University Press 1963).

\textsuperscript{24} S. van Thiel, \textit{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.

\textsuperscript{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, \textit{The Interface of International Trade Law and Taxation} (IBFD Doctoral Series 2013), pp. 42-44.

\textsuperscript{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.

\textsuperscript{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.

Chapter 1 - Setting the Scene

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.
Consumption taxes and VAT

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. 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.

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. 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. 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. France was eventually the first country to introduce a VAT in 1954, based on the proposal of Lauré, then joint director of the French tax authority.

34. E.g. see Due, id., p. 4; Van Brederode, id., p. 17.
37. C.F. von Siemens, Veredelte Umsatzsteuer (Siemenstadt 1919).
40. M. Lauré, La Taxe sur la valeur Ajoutée (Sirey 1952). See also M. Lauré, Au se-cours de la TVA (PUF 1957); and more recently M. Lauré, Science Fiscale (PUF 1993),
Chapter 1 - Setting the Scene

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. Their neutrality also ensured their success against customs duties in the context of trade liberalization. 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.

By any standards, the rise of the VAT system has been a most significant development in tax policy and administration in recent decades. 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, all OECD members have a VAT. 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.

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


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.


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.
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.
sumption taxes should not instead be defined as “taxes on expenditures”.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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”.\textsuperscript{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

\textsuperscript{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).


\textsuperscript{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.

\textsuperscript{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.

\textsuperscript{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”. 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”). 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. The question has been preoccupying economists for a long time 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, 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.

58. PWC, Tax policy and administration – Global perspectives, Shifting the balance from direct to indirect taxes: Bringing new challenges (June 2013).
60. See section 1.2.1.
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).
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”). 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. 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. 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.

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.
consumption taxes and VAT

the excess of input over output tax. 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. 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 yield and both single- and multistage taxes should be collectable roughly at the same time. 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. 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). 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. Finally, the draft by R. van Brederode, Sales Taxation (Kluwer 2009), p. 20.

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

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

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

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.
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.
Consumption taxes and VAT

Consumption taxes and VAT 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.

Chapter 1 - Setting the Scene

the VIVAT system proposed by Keen and Smith, the CVAT suggested by Varsano and McLure, or the dual rate system proposed by Bird and Gendron 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. As transfer pricing has been a major problem in income taxes for decades, it is worth avoiding it, where possible, for consumption taxes.


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)).


Unsurprisingly perhaps, internal indirect taxes are therefore in practice most often applied to domestic supplies and imports, and thus at destination,98 except in some cases of interstate trade within federations or within an integrated economic area. The best example is the origin principle that applies since 1993 within the EU to intra-EU supplies to private consumers.99

Apart from the drawbacks of the origin system outlined above, the main reason that most jurisdictions tax consumption at destination is that destination-based taxes are in principle neutral in the sense that they maintain competitive neutrality between domestic supplies and imports, because the same tax system and thus the same tax burden applies to both. As a result, all sales consumed in a given jurisdiction are taxed according to the same rules and at the same rates, irrespective of the jurisdiction of production.100 Destination systems are therefore thought not to interfere with businesses production and purchasing decisions101 (although it has been argued that the timing of the tax may also distort neutrality between imports and domestic supplies102 and may also cause competition distortions).103

A second main reason for the predominance of destination-based taxes is that, conceptually, the destination rule also better reflects the nature of a...
A third reason that countries apply the destination principle is that a unilateral switch to an origin system would risk increasing cases of double taxation or unintentional non-taxation. A same supply would indeed be taxed twice if the jurisdiction of the supplier taxed at origin while the jurisdiction of the customer taxed at destination. The mirror situation (taxation at destination in the country of supply and at origin in the country of consumption) would lead to unintentional non-taxation. There is a nuance here, however, because even if all states apply the destination principle, risks of double or unintentional non-taxation may still arise, for example, from different definitions or interpretations of the “destination” or “place of consumption” of a taxable supply.\footnote{Specif\textit{ic} inter-jurisdictional issues may also arise in intra-state trade (e.g. in the US) because, as in international trade, different tax rates are likely to cause strong competition between states (and border shopping) and imply substantial administrative and organizational costs for each of them.}

Arguably, the main downside of the destination principle is that it is traditionally implemented by means of “border tax adjustments”, which means imposing a compensating tax on imports and ensuring that exports leave the country free of tax.\footnote{R. Van Brederode, \textit{Sales Taxation} (Kluwer 2009), p. 204. See the 1970 report of the GATT Working Party on Border Tax Adjustment (L/3464) for a definition of border tax adjustments (pt. 4).} The latter is traditionally done by “zero rating” exports, i.e. by exempting export transactions while still allowing a deduction of input tax paid in previous stages of the supply chain (zero rating also applies when the supply falls outside the jurisdictional reach of the tax).\footnote{Technically, a zero-rated supply is a taxable supply on which VAT is charged at the rate of 0\% but which still entitles the supplier to a credit of the input tax. Exempt supplies, on the contrary, are simply not taxed and, accordingly, no input tax credit is available. The VAT Directive does not use the term zero-rating, but refers instead to an “exemption with a right to deduction”.} The exported products thus leave the country free of tax and a compensating tax is levied on imports. One concern with border tax adjustments inherent in a destination-based tax is that they may themselves have the effect of an import barrier and constitute an administrative obstacle to trade because they are traditionally associated with physical border controls.\footnote{See Cecchini Report (1992), which analysed the gains expected from the achievement of an Internal Market in the EU.}
A second main concern is that border tax adjustments, though in principle compatible with WTO and EU law (both allow border tax adjustments for indirect taxes but not for direct taxes), should not be excessive because otherwise they have an effect similar to trade-distorting customs duties or export subsidies. That is why both WTO and EU law require that imported products be granted no less favourable treatment than similar domestic products and that VAT border adjustments or refunds applied in the case of exports do not exceed the tax levied on similar products sold in the domestic market.

A third concern is that, in practice, the destination principle also means that the tax is to be paid in the jurisdiction of the customer, which complicates the compliance burden of suppliers who, in their capacity as taxable persons, will have to assess taxes in accordance with the different rules in force in each jurisdiction of consumption of their supplies and subsequently collect and remit the tax in as many different jurisdictions. In that context, complex, unclear or inconsistent rules across jurisdictions can be difficult to manage and may create uncertainties and substantial additional compliance burdens and costs for the private sector, while seriously undermining fiscal supervision by national tax authorities.
Finally, and as already noted, the application of the destination principle and the related border tax adjustments in a multistage tax like VAT increases opportunities for fraud in cross-border transactions. As a matter of fact, zero rating at export means that tax authorities must pay refunds to exporting businesses even if there is fraud or a failure to pay VAT further down the chain.\footnote{S. Cnossen, VAT Coordination in Common Markets and Federations, Lessons from the European Experience, 63 Tax L. Rev. 583 (2009-2010), p. 12; M. Keen, VAT attacks, IMF Working Paper WP/07/142 (2007), p. 15; J. Mirrlees, Tax by Design, in The Mirrlees Review (Oxford University Press 2011), p. 185; J. Brondolo & C. Silvani, Selected Issues in Administering the VAT: Cross-Checking Invoices and Controlling Refunds to Exporters (IMF 1996); R. Van Brederode, Sales Taxation (Kluwer 2009), p. 251.}

In spite of these drawbacks of the destination principle, most value added taxes are nevertheless levied at destination.\footnote{A retrospective evaluation of elements of the EU VAT system, S. Adam, D. Phillips & S. Smith eds. (IFS 2009); L. Ebrill et al., The Modern VAT (IMF 2001), p. 52.}

\section*{1.2.7. VAT as an economically efficient tax}

There is an ongoing debate regarding the appropriate share or “mix” of indirect taxes (on consumption) and direct taxes (on income). A traditional argument in favour of consumption taxes rather than income taxes is that they would be better for competitiveness, economic efficiency, growth and employment. Consumption taxes would be better for competitiveness because in principle they do not affect the ability of domestic firms to export, as they are either levied at the retail stage only (e.g. US sales taxes) or refunded to taxable persons on export (e.g. EU VAT). In contrast, (corporate) income taxes increase the cost of capital (and hence of production), thus making it more difficult for the affected firms to compete in foreign markets.\footnote{A. Schenk & O. Oldman, Value Added Tax; A Comparative Approach (Cambridge Tax Law Series 2007), p. 35.}

Consumption taxes would also be better for economic efficiency, growth and employment than income taxes because, on the one hand, income taxes (which are traditionally progressive in the sense that the higher the taxpayer’s income, the higher the relative share of the income tax depending on the taxpayer’s ability to pay)\footnote{M. Dassesse, Droit Fiscal, Principes Généraux et Impôts sur les Revenus (Bruylant 2001), p. 29; R. Van Brederode, Sales Taxation (Kluwer 2009), p. 33.} may constitute a disincentive...
Consumption taxes and VAT
to work additional hours and, on the other hand, because income taxes traditionally apply to both the income that is saved and the income from savings,\textsuperscript{120} so that a shift from income taxes to consumption taxes (that would not change total tax revenue) would be expected to encourage savings, which would in turn lead to increased investment and growth.\textsuperscript{121}

There is, however, opposition to the greater use of taxes on consumption, mainly because they are traditionally perceived as regressive and thus unfair. Contrary to income taxes, taxes on consumption indeed apply proportionally to the price of a taxable supply\textsuperscript{122} and thus irrespective of the customer’s level of income, wealth or ability to pay tax.\textsuperscript{123} For that reason, some also consider that the balance between income and consumption taxes implies a political choice between greater economic growth and greater equality.\textsuperscript{124}

Some authors believe the “unfairness” of consumption taxes is exaggerated because consumption tax revenue traditionally finances public spending, including “social spending”, which is mostly relied on by lower-income households.\textsuperscript{125} The argument is in our view rather weak, however, since taxes are not earmarked and basically all taxes, not only non-progressive taxes such as consumption taxes, are used to finance public services.

\textsuperscript{120} J. Due, \textit{Sales Taxation} (Routledge and Kegan Paul 1957), p. 31, with reference to N. Kaldor, \textit{An Expenditure Tax} (George Allen and Unwin 1955).
\textsuperscript{121} OECD, \textit{Consumption Taxes, The Way of the Future?}, OECD Policy Brief of October (2007), p. 5. This should be nuanced, however, in view of the fact that although taxes on consumption exclude savings, they include the income from savings when it is spent.
\textsuperscript{122} Van Brederode notes that there is no VAT system designed to be progressive (R. Van Brederode, \textit{Sales Taxation} (Kluwer 2009), p. 33).
\textsuperscript{123} The same indirect tax may be seen as representing a larger percentage of the income of a low-income household than a high-income household (as the proportion of income that is spent tends to decrease with the level of income). \textit{See} L. Ebrill et al., \textit{The Modern VAT} (IMF 2001), p. 106. For an analysis of this question, see also I. Crawford, M. Keen & S. Smith, \textit{Value Added Tax and Excises: Commentary}, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century (2008); E. Caspersen & G.E. Metcalf, \textit{Is a Value Added Tax Regressive? Annual Versus Lifetime Incidence Measures}, National Tax Journal 47:731-746 (1994). For a philosophical perspective on fairness of taxation and the roots of the ability to pay principle, see R. Van Brederode, \textit{Sales Taxation} (Kluwer 2009), p. 35.
\textsuperscript{124} The question of the (un)fairness of consumption taxes is particularly relevant because there will be less voluntary compliance with a tax that is perceived to be unfair (an example is the poll tax introduced in the UK by M. Thatcher). See R. Van Brederode, \textit{Sales Taxation} (Kluwer 2009), p. 21 and J.B. Slemrod, \textit{Taxation and Inequality: A Time-Exposure Perspective}, Tax Policy and the Economy 6:105-127 (1992).


A mitigation of the regressive nature of indirect taxes is also allegedly achieved through the use of exemptions and lower rates for commodities that are consumed in a relatively higher proportion to total disposable income by lower income households (e.g. clothing, foodstuffs, medicines and social services). It is noteworthy, however, that if reduced rates and exemptions may decrease the regressive nature of the tax, at least when viewed relative to consumption, they also have undesired effects because they apply to all taxpayers indistinctively and for that reason are likely to also offer tax savings to higher-income households. In the end, indirect taxes therefore remain potentially less equitable than direct taxes and in fact, and as noted above, broad-based and general taxation schemes (with minimal exemptions) are preferable because they give rise to less economic distortion.

The unfairness of consumption taxes may also be discussed on the basis of the argument that the fairest tax is actually the one that is based on what people choose to consume and not on what they produce through their labour. In that sense, Schenk and Oldman, for example, consider that income and consumption taxation can be viewed as different aspects of “consumption” in a broad sense, as “income represents the potential power to consume and consumption represents the exercise of the power by consuming goods and services”.

In fact, the question of the appropriate tax mix, or whether to apply a greater share of consumption or income tax, needs to be assessed in the context of each country, not only in terms of efficiency and equity, but also taking account of every aspect of society and every feature of the relevant tax sys-

---

128. E.g. a VAT exemption for children’s shoes such as in the UK allows for a higher tax savings for families buying a EUR 100 pair of shoes, as compared to a family buying a EUR 20 pair of shoes, while it may be assumed that the former family has a higher disposable income than the latter.
130. E.g. see M. Dassesse, *Droit Fiscal, Principes Généraux et Impôts sur les Revenus* (Bruylant 2001), p. 22, with reference to N. Kaldor, *An Expenditure Tax* (George Allen and Unwin 1955). This is actually a very old argument that can be traced back to Hobbes’ Leviathan.
Consumption taxes and VAT

tem (i.e. whether consumption taxes are broadly applied or only target specific products, or whether or not income taxes are progressive). Historical and economic factors also have an influence on the way revenue is raised because income taxes prove more difficult to collect in predominantly rural economies where people are widely dispersed. Finally, social and demographic factors may also play a role. In its 2010 Green Paper on the future of VAT, for instance, the European Commission not only stressed the relative efficiency of consumption taxes (because of a broader and more stable base than profits and incomes), but it also mentioned the impact of ageing societies on labour markets, savings and consumption patterns and public expenditures in the years to come, meaning that states will have to rely less on income and savings taxes and instead favour consumption taxes.

In any case, the stormy development of VAT in the last 40 years contradicted early predictions of economists who expected the increased reliance on indirect taxes to be a mere passing phase in their development, with income taxes likely to take over.

After this summary description of the main features of the VAT system, the next section explains why, in broad terms, it proves difficult to apply value added taxes to online supplies.

1.2.8. The harmonized EU VAT system

Historically, VAT harmonization in the EU has been closely linked to the objective of achieving full economic integration between the Member States, first in the form of a common market and subsequently in the form of an internal market without frontiers and an economic and monetary union. The reason is that economic integration under these respective frameworks required the abolition of any obstacles to the intra-Community free movement of products and production factors, including tax obstacles,

135. Article 2 of the 1957 *Treaty of Rome* placed the creation of a common market at the heart of the European economic integration process.
because taxes are recognized to have a significant impact on private sector behaviour. For that purpose, the founding Member States agreed in the 1957 Treaty of Rome to eliminate customs duties and measures with equivalent effect on intra-Community trade and to abide by a prohibition of indirect tax discrimination against imports (further discussed in chapter 3). The Treaty further called for the harmonization of all indirect taxes between the Member States because disparities between the different national systems could still have caused internal trade barriers.

In practice, the harmonization of the Member States’ VAT systems has been a lengthy and difficult process because all tax decisions in the EU are subject to the unanimity rule, a requirement that has become more burdensome in view of the EU’s successive enlargements from 6 to 28 Member States. In spite of this difficult decision-making context, the Member States have agreed to comply not only with the fundamental Treaty principles and, in particular, the directly applicable principle of non-discrimination, but also with a harmonized VAT framework that has come about in different important stages.

The first main step in this process was the adoption, subsequent to a number of important studies, of the first and second VAT Directives in 1967, which committed the Member States to replace their cumulative sales taxes with a common broad-based multistage non-cumulative VAT.

---

137. 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) and references.
138. Customs duties on intra-Community trade were a primary target of articles 12 to 29 of the 1957 Rome Treaty and they were completely eliminated by 1969.
139. Article 95 of the 1957 Treaty of Rome, now article 110 of the TFEU.
140. Article 99 of the 1957 Treaty of Rome now article 113 of the TFEU.
142. The unanimity rule (article 113 TFEU) applies to all tax matters, while the co-decision procedure applies in most other areas of competence, giving co-decision power to the European Parliament and switching from a unanimity vote to a qualified majority vote in the Council. Y. Devuyst, The European Union Transformed (P.I.E.-Peter Lang 2005).
The need for further harmonization rapidly arose after the adoption of these two first directives because Member States still had full discretion to set the tax rate and to provide for exemptions, which resulted in distortions (e.g. border shopping), contrary to what the directives had predicted. In addition, diverging (implementing) national rules in practice resulted in cases of double or unintentional non-taxation giving rise to distortions in intra-Community trade. Against this background, the decisive push came from the “own resources decision” in 1970 which provided that all Member States should contribute part of their VAT revenue to the Community budget, which again required the harmonization of the VAT basis of assessment in order to ensure an equal participation by Member States. Against this background, a second main step in the harmonization of the EU VAT was made with the adoption of the Sixth VAT Directive in 1977, which provided for much more detailed provisions and much less discretionary powers for the Member States, e.g. as regards exemptions. New provisions were also added concerning the place of taxable supplies.

In subsequent years the Sixth VAT Directive was often amended but a major change, which can be considered as the third main step in the evolution of the harmonized EU VAT system, was the adoption of the “transitional system” in the framework of the establishment of the internal market without frontiers in 1992. In the preparatory process for the internal market the European Commission had proposed a switch to the origin system for intra-Community supplies so as to be able to abolish border tax adjust-

---

145. The Preamble of the First VAT Directive had predicted that the replacement of the cumulative multistage tax systems by a common system of VAT would result in neutrality in competition “even if the rates and exemptions are not harmonised.”
147. On the basis of 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, the budget of the Community since 1 January 1975 is financed entirely from the Communities’ own resources, including customs duties, agricultural levies and a part of VAT revenues.
150. A link to acts amending and related to the Sixth VAT Directive can be found at: http://europa.eu/legislation_summaries/other/l31006_en.htm#AMENDINGACT.
ments, which constituted undesirable trade obstacles. Even though this had been requested by Member States, no agreement could be reached, because a switch to the origin system would have caused shifts in revenue of Member States (no satisfactory method for redistributing tax revenue could be found) and, in the absence of rate harmonization, it would also have resulted in competition distortions, particularly in border areas. Instead, Member States agreed on a transitional system that entered into effect on 1 January 1993, under which intra-Community supplies to private consumers are taxed at origin but the destination principle still “temporarily” applies to transactions between taxable persons. For B2B supplies, tax formalities at the borders were suppressed and border tax adjustments were shifted to corporate accounts and VAT returns (border declarations no longer being necessary). Also, some approximation of tax rates was agreed after intense negotiations. To support the transitional system, a verification and information exchange system (“VIES”) was created, under which suppliers are required to report intra-Community supplies and

---

152. See article 4 of the First VAT Directive.
153. An origin-based tax indeed results in a tax revenue shift to the benefit of net exporting countries. Proposals were made to mitigate this effect and allow for a redistribution of revenue but failed to convince Member States.
154. Except for new cars and other means of transport as well as distance sales above a certain threshold (articles 33 and 34 of the VAT Directive).
158. Council Regulation No 218/92/EEC of 27 January 1992 on administrative cooperation in the field of indirect taxation, OJ L24, 1 February 1992. The VIES was initially only available for goods; it was extended to services in 2004.
customers are required to report their intra-Community acquisitions, allowing for cross-checking.

The transitional system was meant to apply for a period of 4 years from the suppression of the internal borders on 1 January 1993, but Member States never agreed on a “definitive” origin-based system. As of 2000, the European Commission therefore decided to postpone the introduction of an origin-based VAT \emph{sine die}. The focus then shifted to fraud issues and to recasting the many different pieces of legislation into one single Recast VAT Directive (2006/112/EC of 28 November 2006),\footnote{The preamble of the Recast invokes reasons of clarity and rationalization (pt. 2).} which entered into force on 1 January 2007 (and has already been amended several times). In 2012, the Commission eventually announced that it had abandoned the objective of setting up an origin-based harmonized VAT.\footnote{See European Commission, \textit{Future VAT system: pro-business, pro-growth}, Press Release IP/11/1508.}

The EU VAT system is the oldest VAT system currently in application.

\section*{1.3. How to tax online supplies?}

\subsection*{1.3.1. Online supplies – Definition and relevance}

In the 1960s, US researchers developed a means of communication between selected universities, which essentially allowed for the exchange of e-mails between them. When technical developments in the 1970s allowed for communication across networks, the Internet was born, but it was the creation by CERN researchers of the World Wide Web in 1990 that permitted the Internet to turn into a broadly used medium.\footnote{See R. Zakon, \textit{Hobbes’ Internet Timeline} (RFC 1997). \textit{See also} C. Gringras, \textit{The laws of the Internet} (3rd edn) (Tottel Publishing 2008).} In short, the Internet consists, on the one hand, of physical infrastructures that together form a network and, on the other hand, of a new “online” (as opposed to an “offline” or “conventional”) forum where both economic and non-economic activities are carried out.\footnote{A. Cockfield, \textit{Designing Tax Policy for the Digital Biosphere}, Conn. L. Rev. 335, p. 336 (2001).}

Internet development is impressive and far exceeds the emergence of any of the preceding communication technologies.\footnote{R. Doernberg & L. Himmels, \textit{Electronic Commerce and International Taxation} (Kluwer 1999), p. 3.} Fewer than 40 million

people were connected in 1996, more than 100 million in 1997, more than 300 million in 2000 and more than 2 billion in 2011. Nowadays, approximately 70% of OECD households have access to the Internet at increasingly higher speeds and lower costs. In two thirds of OECD countries, more than 95% of the companies use the Internet, with only a small proportion of the smallest businesses not yet connected. In 2010, only 5.7% of small firms (10-49 employees) in the EU25 were not connected.

The opening up of the Internet to both business and private use created new forums for social interaction, but also greatly facilitated international trade by allowing for the commercialization of products in circumstances that no longer require a degree of physical presence. At the same time, it supported the development of new activities by prompting the creation of new, “digital”, products, which have their own production and distribution schemes. These elements combined have resulted in a new commercial and entrepreneurial environment – “e-commerce” – in which business models are no longer constrained by geographic distances and borders, and cross-border supplies have become as easy to conduct as domestic supplies.

“E-commerce” can be defined in broad terms as “the production, advertising, sale and distribution of goods and services via telecommunication networks”. This definition covers not only transactions made through the Internet, but also transactions made through other telecommunication networks such as broadcasting or the transmission of sound, images, data or other information by telephone (including mobile, as well as business

---

166. Id., p. 3. According to Eurostat, in the 27 EU Member States, Internet access by companies stood at 94% in 2009. The statistics are available at http://epp.eurostat.ec.europa.eu/portal/page/portal/information_society/data/main_tables (Survey on ICT in enterprises 10+ employees excluding the financial sector).
network services, teleconferencing and support services), telex, telegram, radio and television, mail order catalogues or mail order advertising.

A more limited definition of e-commerce focuses on the transactions that are primarily made through the Internet (“online transactions”). Online transactions are nowadays attracting a lot of interest in view of the unique opportunities that the Internet is offering, i.e. the possibility to conclude deals on an interactive basis, with one or many people, unconstrained by time, space and borders, in a multimedia environment with sound, image and text transmission, and typically at low costs.

The definition of e-commerce can be further narrowed down to the concept of “online supplies”, i.e. supplies that are not only ordered, but also fully delivered or performed via the Internet. In virtually all online transactions, the search for a product by a customer as well as its ordering and payment will – or at least may – be performed online, but a further distinction then occurs between, on the one hand, tangible goods and conventional services that may be ordered online but must be “physically” delivered (hereinafter referred to as “distance sales”) and, on the other hand – and which is the most notable contribution of Internet technology – supplies that are not only ordered and paid online, but that are also delivered/Performed online (referred to in the remainder of this study as “online supplies”, “e-commerce” or “digital” supplies or deliveries, as opposed to “conventional supplies” and “conventional commerce”).169 As will be further discussed in section 1.3.2., while distance sales (e.g. of clothes or books or travel services performed in the tangible world) still rely on traditional forms of distribution and for that reason do not put pressure on conventional tax concepts built on the physical reality of trade,170 online supplies, such as e-books, downloadable music and e-learning modules, never “physically” cross borders nor require any intervention in the tangible world from the supplier. In addition, online supplies are made between two parties that are not necessarily engaged in any other contractual relationship, unlike the parties to supplies made via other electronic networks – such as traditional telecommunication or broadcasting networks – which usually take place in the context of a broader contractual relationship. This is why online supplies are giving rise to unprecedented tax challenges that are proper to the

169. The European Commission used the terms “direct” vs “indirect” e-commerce to distinguish online supplies and distance sales. See European Commission, A European Initiative in Electronic Commerce COM(97) 157 (1997).

Chapter 1 - Setting the Scene

Internet sphere and therefore deserve a specific analysis,171 which will be the subject of this research.

The variety of online supplies on offer is impressive and can be expected to grow further. Already at present, an “online customer” may purchase supplies as different as music, movies, books, artwork, cooking recipes, sewing or knitting patterns, IT services (anti-virus, web hosting, mastering and maintenance), traditional consultancy services (supplied by lawyers, accountants, financial and investment experts and career development and coaching consultants), gaming, gambling, design software and tools, networking tools, e-learning modules, online teaching or tutorials, online libraries, news, stock exchange information, weather forecasts, sport results and so on. An online supply can often be “linked” to a traditional good (e.g. CDs or DVDs, pictures, letters, newspapers, books, often characterised as “intangible goods” or “content” in their digitized form) or service (e.g. language courses or professional advice) and the process through which these traditional supplies are now available on the net is known as “digital convergence”.172 Some online supplies, however, were developed around the Internet and therefore cannot be linked to a supply in conventional commerce (e.g. web hosting, data processing). A hybrid type of online supplies is also developing, i.e. the supply of tangible goods over the Internet via 3D printer technology. In this case, the customer will effectively acquire a tangible asset, but through the intangible medium of the Internet.173

This wide and growing variety of online supplies makes it difficult to determine with precision the volume, and thus the economic importance, of

173. 3D printer technology is a very promising development in very diverse areas. It allows, for example, the production of basic spare parts for washing machines or cars, but is also used in the sector of biomedical engineering. The creation of a baby’s airway splints via a 3D printer is described in the May 23 issue of the New England Journal of Medicine.
online supplies. Neither UN\textsuperscript{174} nor WTO\textsuperscript{175} trade classifications or statistics offer separate information or figures on online supplies but rather integrate them into broader categories of “services”, simply because of their intangible nature. UN and WTO trade statistics are thus unable to produce useful figures to identify the volume of online supplies because they do not isolate them in a specific category. While in a general economic sense this approach is valuable because the way a product is delivered is less important than the sector concerned, the result is that it is impossible to obtain reliable figures on the volume of online supplies in our economy.

Nevertheless there are some useful estimates. A 2012 OECD report indicates that advertising represents the biggest online market in absolute terms, followed by computer and video games, online music and film and video. According to collected data, games accounted for 39\% of digital revenues in 2010 and digital music worldwide accounted for 29\% of recording companies’ revenues, which, the OECD notes, is more than four times that of the combined online revenues from the book, film and newspaper industries, despite these other industries being much larger overall.\textsuperscript{176} The OECD, however, again, does not offer a complete picture of the e-marketplace, but recognizes that “the Internet is becoming a key economic infrastructure, revolutionising businesses and serving as a platform for innovation.”\textsuperscript{177}

Private firms also estimate trade flows but the problem is that most of these surveys again use figures on all online transactions, i.e. both distance sales and online supplies indistinctively (both using Internet technology, but to a different extent),\textsuperscript{178} or, if they do differentiate between the two, it is only done for a single sector.\textsuperscript{179}

\textsuperscript{175} GATS, \textit{Services Sectoral Classification List}, (W/120). This classification is not binding for states but is widely acknowledged.
\textsuperscript{179} E.g. Research and Markets announces that the global online gambling industry has reached a net worth of USD 30 billion in 2012 and is expected to continue to grow in the coming 5 years. They unfortunately do not offer such detailed analysis for all online supplies.
Chapter 1 - Setting the Scene

Even though current statistics do not therefore help to identify the exact volume of online supplies,\textsuperscript{180} it may nevertheless be safely assumed that the volume of online supplies substantially increased over the years and will continue to increase because online supplies are easy to make, cheaper than conventional supplies and crisis resistant.

First of all, online supplies are easy, both for suppliers and for consumers, because they take place without regard to location and time constraints and through an increasing variety of devices. For suppliers, relying on Internet technology facilitates the conclusion of international transactions and increases their market coverage, including for small and medium-sized enterprises which will find it easier to engage in international commerce.\textsuperscript{181} According to the OECD and the European Commission, more and more suppliers integrated e-commerce in their mainstream activities.\textsuperscript{182} In 2008, 12\% of total enterprise turnover was made online, compared to 2\% in 2005.\textsuperscript{183} The OECD, however, notices that businesses rely more on the Internet for purchasing than for selling (e.g. in 2010, on average, 35\% of all businesses with ten or more persons employed used the Internet for purchasing and only 18\% for selling goods and services).\textsuperscript{184}

For consumers, the possibility of digital convergence has greatly facilitated the way they can obtain and enjoy information, entertainment, professional and everyday services. A main reason is that with the support of Internet technology, online supplies may be delivered between any two places in the world and at any time in just a few seconds. Moreover, digital material, such as downloadable music or pictures, is of high resolution and hence of far better quality than material supplied on an analogue medium. Finally, online supplies may be reproduced and stored without limits, while still

\textsuperscript{180} In general, measuring services trade flows proves a difficult exercise because statistics are mostly based on disparate sources of information such as business accounting and record-keeping, administrative sources, surveys and other estimations. United Nations, \textit{Manual on Statistics of International Trade in Services} (2010), p. 4.
\textsuperscript{182} \textit{The future of the Internet economy, a statistical profile}, OECD Ministerial Meeting, Seoul, South Korea, June 2008.
How to tax online supplies?

maintaining the same quality. Interesting in that respect is that many early reports held that B2B supplies dominated the e-commerce sector.\(^{185}\) While the argument may have been valid in the early years of e-commerce, it can no longer be reasonably maintained because online supplies have become so much more accessible for consumers as a result of improvements in bandwidth capacity (available at low cost), the development of more secure electronic soundproof lines and, most importantly, the diversification of devices (smartphones, tablets) and access media (wireless, satellite, etc.) that allow consumers to purchase online.\(^{186}\) Mobile Internet connectivity from an ever-growing number of different devices capable of accessing online content is indeed changing the way in which people consume.\(^{187}\) Sources of content are also expanding for private consumers, with social networking and new video and audio services.\(^{188}\)

Secondly, apart from the fact that digital convergence has greatly facilitated online supply and consumption at a global level, online supplies are comparatively more affordable than conventional supplies because of lower transport and transaction costs and because “bits” are much cheaper than the raw materials used for manufacturing tangible items.\(^{189}\) Setting up and running an “online business” is also cheaper as compared to setting


187. OECD, *Internet Economy Outlook 2012 highlights*, OECD Publishing (2012), p. 4. According to the International Telecommunications Union, Internet access via mobile devices is a growing market: in 2009 there were 667 million mobile broadband subscriptions. See also the recent *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, p. 3.


Chapter 1 - Setting the Scene

up and running a “conventional business”, which therefore allows for cost cutting and, again, lower prices.  

Thirdly, while the economic crisis that started in 2007 affected nearly all countries and sectors, e-commerce seems to have avoided the tempest to become a stronghold of continued growth. According to the International Data Corporation, in spite of the crisis, the number of Internet users who made online purchases in 2009 was 624 million worldwide, confirming the sustained development of e-commerce internationally. Collins Stewart LLC expected global e-commerce sales to reach USD 694bn in 2012, up from USD 448bn in 2009, resulting in a 15.8% compound annual growth rate, a spectacular increase in view of the global economic slowdown of the past years.

Finally, more in an economic sense, the proliferation of e-commerce is predicted to further lower transaction and production costs, which should facilitate market entry and increase competition. This in turn should lower prices, increase quality and create new and more diverse products, thereby increasing economic growth and welfare generally. As a consequence, e-commerce is likely to be one of the greatest economic and social developments of the 21st century, leading to major structural changes in the economies of both developed and developing countries, hastening the progress of globalization, encouraging the dismantling of trade barriers and spurring growth and employment.

In conclusion, e-commerce is no doubt a successful and growing sector of the global economy that is capable of creating economic growth and welfare, but the fact that it takes place in a non-physical and borderless world also has major consequences on our traditional tax systems, as will be discussed in the next section.

1.3.2. Difficulties of taxing online supplies

Against the background of a rapidly expanding volume of e-commerce, the question of to what extent it is necessary to adapt traditional regulatory systems to this newly developing “digital” economy and its specific characteristics has been the subject of extensive discussions between academics and policymakers.197

The question arises first and foremost because online supplies take place on a global198 and virtual marketplace, the “e-marketplace”, which, unlike the “conventional marketplace”, is not limited by space or time because it is neither situated at a particular geographic location nor bound by opening hours. As a consequence, the location of the parties to an online supply and their respective time zones are no longer relevant. Another characteristic of the “e-marketplace” is that the contracting parties only meet “virtually”, excluding any form of traditional or “physical” contact, so that the Internet, as currently structured, offers a relative anonymity to its users. Yet another characteristic is that the actual delivery of online supplies takes place


198. McLure notes that although it could in theory be global, it is in practice concentrated in developed nations. C. McLure, Taxation of Electronic Commerce in Developing Countries, paper presented at the conference Public Finance in Developing and Transition Countries, held in Atlanta in honor of Richard Bird (2001).
through the Internet, which as a borderless medium that ignores geography and time constraints, allows for a low-cost and immediate high-speed transmission of data at any time and from any origin to any destination (no transport costs). In that respect, a particularity of online deliveries is also that they do not necessarily take place in one go: data transferred over the Internet is indeed typically broken up into millions of packets only to be reassembled at the final point of destination.\textsuperscript{199}

The global nature of the e-marketplace combined with the relative anonymity of Internet users are the very reasons that e-commerce poses challenges to traditional regulatory systems. As a matter of fact, because these systems are traditionally based on territorial concepts meant to apply to physically identifiable subjects and linked to the (geographically limited) national jurisdiction of the enacting states,\textsuperscript{200} it is for e-suppliers extremely complicated to be “globally” compliant on the e-marketplace, in view of the multitude of national regulations that apply simultaneously. For example, regulations on advertising outlaw the use of English in France, advertising to children in Denmark and comparative advertising in Germany, while the content of a website, including advertising on that website, is available globally.\textsuperscript{201}

In addition, the enforcement of national legislation in cross-border online supplies is most problematic in view, first, of the limited capacity of states to enforce their laws beyond their territorial limits (limited jurisdictional reach)\textsuperscript{202} and, second, because of the difficulty to identify Internet users (anonymity as an obstacle to enforcement even within jurisdictional reach).\textsuperscript{203}


\textsuperscript{200} The editorial introduction of the Swiss Political Science Review 5(1) dedicated to “Internet Governance”, notes that: “Whereas the logic of the Net is borderless, the logic of national politics remains territorially bounded” (p. 115 (1999)). Cockfield notes that: “[T]he old world of regulating atoms has little to offer a world of bits and bytes that zip about the planet at the speed of light” (A. Cockfield, \textit{Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation}, 85 Minn. Law Rev., 1172 (2001)).


How to tax online supplies?

The borderless, decentralized and anonymous nature of the Internet may therefore frustrate states’ attempts to enforce legitimate policy goals. Well-known regulatory issues, for example, have arisen concerning the application and enforcement of data protection laws, intellectual property and consumers’ rights. Internet users themselves may likewise be confronted with great difficulties for the enforcement of contractual obligations.

A key underlying issue is that no single person or body owns or governs the Internet. Interestingly, some defend the idea that the Internet should remain a “free zone”, i.e. free from any form of state regulation. This libertarian discourse is most popular in the US, and particularly in electronic communities. In practice, however, the Internet is abundantly regulated,

---


from two different angles, i.e. as regards its technical aspects and as regards its contents.

On the technical side, both states and non-state actors have participated in the development and shaping of the Internet under a multi-stakeholder form of governance now labelled as “Internet governance”.211

Non-state actors involved in Internet governance included, for example, the Internet Corporation for Assigned Names and Numbers (ICANN), the Internet Engineering Task Force (IETF), the Regional Internet Registries (RIRs), the Internet Society and the World Wide Web Consortium (W3C).212

In practice, and stemming from the definition given above, “Internet governance” focuses on the technical aspects of the Internet and on questions such as how to make it a stable, accessible, reliable and secure network (this includes, for example, the design of Internet protocol, the allocation of domain names, the coordination of critical Internet resources and encryption of data). In other words, Internet governance concerns the technical management of Internet infrastructure and, broadly, refers to how Internet service providers, protocol developers and network operators have over time voluntarily agreed to respect policy decisions over the technical underpinnings that enable the Internet to function (regulation “of” the Internet as a network).213 In spite of a relative confusion regarding the distribution of tasks and powers (as non-state actors do not always operate under or pursuant to formal government authority),214 the participation of non-state actors is widely acknowledged as being a key element of the well-functioning of the Internet as a network.215 Another major advantage of the multi-stakeholder model is also that it allows to a certain extent non-state


How to tax online supplies?

actors “monitoring” states’ actions and preventing, or at least exposing, inappropriate states’ interferences such as access restrictions or content filtering in breach of the freedom of expression and right to information. Admittedly, however, and in spite of vivid reactions and opposition from non-state actors and in particular from civil society, many states do restrict access to the Internet or filter content. In fact, whenever a technical question (in this case, access to the network) has policy implications (in this case restriction of the freedom of expression and the right to information), some states just implement their national policies and ignore non-states actors’ arguments and claims.

This leads us to the second angle from which the Internet is being regulated: the regulation of activities taking place “on” the Internet. As noted above, a multitude of national regulations apply. More precisely, on the one hand, all national regulations in principle apply indiscriminately “offline” and “online” (e.g. defamation, invasion of privacy, tax evasion), in spite of well-known limitations concerning their enforcement, as discussed above. On the other hand, special laws are adopted to allow for a more effective implementation and enforcement of the regulation of activities taking place “on” the Internet (e.g. infringements of intellectual property rights which have multiplied on this forum).


220. On the relevance of applying different rules on the Internet, see Lessig, who argues that existing works should enter the public domain in a reasonably short period of time (L. Lessig, The Future of Ideas: The Fate of the Commons in a Connected World, (Random House 2001).
lations, and in stark contrast with the multi-stakeholder approach that prevails for the shaping and functioning of the Internet as a network, non-state actors often have little decisional or operational power, even if they are increasingly required to “cooperate” with state actors to ensure enforcement of criminal rules against piracy, child pornography or terrorism.221 Non-state actors may also be consulted at some point in the legislative process, or issue guidelines and best practices,222 but in the end, all they can do is try to influence the decision-making process without having decisional power of their own.223 In other words, states have a free hand to regulate activities taking place on the Internet.

However, and as will be further discussed in section 1.3.3., governments around the world have rapidly sensed the need to cooperate and coordinate internationally when defining policies on and regulation of activities taking place “on” the Internet, e.g. in the areas of consumer protection, privacy protection, trade policy and market access, competition law and policy, electronic finance, e-government, education, etc.224


222. E.g. W3C published a draft standard for online privacy: http://www.w3.org/standards/webdesign/privacy.

223. In view of this fundamental difference (i.e. the multi-stakeholder approach to the regulation “of” the Internet and states having a free hand in regulating activities taking place “on” the Internet within their territory), we share the view that the governance “of” the Internet and the governance of activities taking place “on” the Internet should be clearly distinguished. N. Cukier, Internet Governance and the Ancien Régime, Swiss Political Science Review 5(1), p. 127 (1999).

In that context, the question of how to tax economic activities carried out on the e-marketplace in an efficient and coherent manner quickly emerged, because “what may be a sound rule from a tax policy perspective may be totally unworkable in the light of available technology”.225 The global, decentralized and anonymous character of the e-marketplace indeed challenges states’ traditional taxation approaches and regulations. In particular, it challenges the application of the traditional standards for determining jurisdiction to tax, sourcing of income, nature, value, situs and timing of sales, the classification of property and taxpayers, and also the collection of taxes.226

In the field of direct taxes, international conventions have multiplied to rationalize concurrent claims to taxing jurisdictions for the sake of avoiding double taxation or unintentional non-taxation, and they are usually based on the OECD Model Tax Convention on Income and on Capital.227 Unfortunately, the technologies that made e-commerce possible challenge these existing mechanisms, which are mostly based on territorial concepts and have traditional business models in mind.228 Tax jurisdictions have tried to tie online supplies back to geography and discussions focused on how to define the “place of effective management” for purposes of the tiebreaker rule of article 4 of the OECD Model Convention that determines corporate residence. The Commentary to article 4 clarifies that the “place of effective management” is the place where “key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made”. But where are the decisions “in substance made” when a multinational company convenes its management board via video-conferences that are organized each month in different locations? The OECD Commentary merely recognizes that some countries consider a case-by-case approach the best way to deal with difficulties that “may arise from the use of new communication technologies”.229

---


Chapter 1 - Setting the Scene

Another well-known problem related to source-based taxation is how to interpret the concept of permanent establishment (as defined under article 5 of the OECD Model as “a fixed place of business through which the business of an enterprise is wholly or partly carried on”) in the context of e-commerce. In that respect, for instance, it has been clarified that a website cannot, in itself, constitute a permanent establishment and that website-hosting arrangements typically do not result in a permanent establishment for the enterprise that carries on business through the hosted website.230

Yet another question is how to qualify income from online supplies. For instance, should the income from downloadable software or music be qualified as “business profits” of a permanent establishment, or as “royalties” or perhaps as a “fee” for technical services. The question is important because different tax rules and tax burdens may apply to different kinds of income.231

Finally, questions arise on how to properly enforce an income tax in the age of the Internet. On the one hand, the increased “mobility” offered to taxpayers by Internet technology indeed allows them to “move” outside the jurisdictional reach of a state (tax avoidance, e.g. by moving the place of effective management of an online company to a tax haven, cf. our example above). On the other hand, the relative anonymity of the Internet and absence of traceability of online supplies allows taxpayers who stay within the jurisdictional reach of a state to nevertheless escape the payment of taxes (tax evasion, e.g. by understating income generated).

While the application of direct taxes to online supplies thus raises numerous questions, some of which still remain unsettled, the difficulties related to the application of consumption taxes to these supplies are even more acute.232

As a matter of fact, in the field of consumption taxes, a first challenge is the absence of international coordination regarding tax jurisdiction.233 While many international conventions seek to avoid that a same person be taxed more than once, there are indeed no international conventions to avoid that

231. On that question in general, see OECD, id.; see also W. Hellerstein, Electronic Commerce and the Challenge for Tax Administration, World Trade Organization, Committee on Trade and Development, Seminar on Revenue Implications of E-Commerce for Development, p. 12 (2002).
233. See Ecker’s proposal for a “A VAT/GST Model Convention” (T. Ecker, A VAT/GST Model Convention (IBFD Doctoral Series 2013)).
a same product or service be subject to consumption taxes in more than one jurisdiction. The broad reliance on the destination principle in most consumption tax systems (as discussed in section 1.1.6.) in principle ensures a certain level of coordination, but, as noted, double taxation or unintentional non-taxation may still arise, e.g. if the place of consumption/jurisdiction of destination is defined differently across jurisdictions.

Because it is impossible for both practical and economic reasons to perform pure consumption tests, a “prediction” about where the customer is likely to use the supply is traditionally made through “approximations” (“proxies”). Relying on proxies provides clarity and legal certainty and limits compliance and administration costs, and, although the use of proxies admittedly does not ensure that a supply will be taxed where consumption effectively takes place, it should simply be seen as “a pragmatic way of implementing the destination taxation logic”.

Relying on proxies to implement the destination principle, however, still requires international coordination on the choice of the proxy and the exact definitions used. Traditional proxies include the location, residence or place of business of the supplier or the recipient of a supply, the location of the object of the supply, the place of performance of the supply or the location of an item to which the supply relates. Two additional proxies that are

235. Take as an example the development of a piece of software by a supplier who is located in jurisdiction A for a business customer who is located in jurisdiction X, but who downloads the software in jurisdiction B and eventually uses that software at a business conference in jurisdiction C. In such a case, the supplier cannot be required to identify the place of consumption (by reference to the downloading activity by the customer? or by reference to the use during the conference? and quid if the software is downloaded or used several times in different places?).
237. Since this book covers both B2B and B2C supplies, but because consumption is traditionally understood in the sense that only end consumers consume, we assume that identifying a “place of consumption” for B2B transactions is nothing more than a simplified way of describing the place where taxation of B2B transactions should occur in a destination-based system.
239. The traditional proxies are classified as “intangible” in the sense that they relate to features of the entities involved in the transaction rather than to physical objects. 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, Com-
Chapter 1 - Setting the Scene

now commonly found include the location, residence or place of business of a person other than the recipient of the supply to which the supply is effectively provided or by whom the supply is received and the place of effective use and enjoyment of the supply, which are getting much closer to a genuine consumption test. Even if there is a general consensus on the relevant proxies for defining the place of consumption of goods (i.e. at the place where these are effectively located), there is room for discussion on the appropriate proxy for defining the place of consumption of services. As noted above, the confrontation of different interpretations will inevitably result in double or unintentional non-taxation. Furthermore, even where two jurisdictions in theory use the same proxy, a common interpretation is also required. For example “residence” might include (or not) domicile and second residences, “place of establishment” may refer (or not) to the corporate seat or principal place of activity. International coordination is therefore necessary up to the smallest level of detail. Finally, different classifications of supply may also lead to the application of different jurisdiction rules, again potentially resulting in double taxation or unintentional non-taxation.240

The absence of international coordination regarding tax jurisdiction for consumption taxes therefore constitutes an obstacle to cross-border trade in general. It is even more the case for e-commerce given online supplies are “cutting through national borders with ease”.241 An additional difficulty regarding tax jurisdiction and value added taxes is that when a tax authority has jurisdiction over a consumer in a cross-border supply, he will not automatically have jurisdiction over the supplier who collects the tax.242 The question of jurisdiction thus arises in a different context than in direct taxes (and as will be discussed, the enforcement of VAT on taxable persons on which the state does not have jurisdiction is a most problematic issue).

240. Cases of unintentional non-taxation are perhaps more difficult to find, although the OECD holds that they are as frequent as risks of double taxation due to the symmetric nature of VAT (and GST). See OECD, The application of Consumption Taxes to Trade in International Services and Intangibles, para. 30 (2004).
A second challenge of applying VAT to online supplies is how to deal with the difficulties that stem from the fact that traditional VAT systems were developed when trade in goods constituted the bulk of international supplies and for that reason were designed on the basis of the “tangible” nature and assumed “physical” move of the taxable base across physical borders to a readily identifiable destination.\(^ {243}\) Traditional VAT rules therefore prove – by design – inappropriate for e-commerce, which has created a dynamic and global market in supplies of an intangible nature in which the proximity and, more generally, the location of the parties in the transaction has become irrelevant, since online supplies flow from one location to another without regard for distance and jurisdiction in an instantaneous and mostly anonymous way and with low or no transport costs.\(^ {244}\)

The “ability to respond to markets without concern for geography and time through a medium that is ubiquitous and instantaneous”\(^ {245}\) constitutes a major advantage in a global market economy, but it also poses unprecedented challenges from a tax perspective. In practice, indeed, how can territorial jurisdictions possibly identify taxable supplies and enforce VAT on these supplies when the Internet offers mobility without location, anonymity for the suppliers and consumers and the non-traceable transfer of content?\(^ {246}\)

The reliance on tangible concepts in the design of value added taxes was a source of concern even before the advent of e-commerce, namely for the taxation of any “intangible”, i.e. for services in general, but both the nature and the value of online supplies make these concerns much more pressing. Indeed, on the one hand, the nature of online supplies and of the


relationship that develops between the parties in this type of transaction is fundamentally different than in conventional supplies of services. As a matter of fact, online supplies increasingly concern digitized goods (such as e-books, movies and music) and as noted already, online supplies are available at all times, quasi-instantaneously, in an automated way, without need for any geographic connection between the parties. Accordingly, online suppliers are most likely to be unaware of the destination of their supplies and the identity of their customers. This does not matter from a commercial perspective, but it has a major impact on the level of information that is available to the suppliers for assessing the tax, and that traditionally requires the identification of the jurisdiction of consumption (as a proxy for the implementation of the destination principle, which is the rule that prevails in cross-border transactions). From a tax enforcement perspective, both the intangible nature of online supplies and the relative anonymity of the parties to an online supply also create enormous problems for taxing authorities in establishing audit trails, in verifying parties to transactions or even in determining whether a taxable supply is taking place, in obtaining documentation and in fixing convenient taxing points. Accordingly, the instantaneous and automated delivery of online supplies to hardly identifiable customers constitutes a major development in the way commercial activities are carried out that traditional VAT systems were not prepared to handle. These specific jurisdiction rules and related tax assessment and implementing provisions that apply to online supplies under the current EU VAT framework will be further described and assessed in section 2.3. of chapter 2.

On the other hand, because Internet technology blurs the concept of distance, the number of cross-border supplies of intangibles is much higher on the e-marketplace, with major consequences from a tax collection perspective. Until recently, cross-border supplies of intangibles (i.e. so far only services) remained limited in practice. Most services indeed used to be “personal” and “non-transportable”, meaning that the immediacy of the relationship between the supplier and the customer was crucial. In-
international supplies would thus typically occur through the geographical
move of one of the parties to the transaction, i.e. either the customer would
tavel to the country of the supplier, or the supplier (or his representative)
tavel to the country of the customer or supply through a commercial
presence there. For this reason also, the majority of cross-border supplies
would involve an actual cross-border movement and would thus naturally
occur between neighbouring jurisdictions that often share similar tax tradi-
tions, and require contacts (be it by letter, phone or fax) between the parties
(gravity model of trade in international economics).\textsuperscript{251} In contrast, online supplies are delivered worldwide and are universally
accessible on personal computers, smartphones, tablets, digital radios or
high-definition televisions, without any inconvenience for the customers
related to distance, which neither alters the price and speed of the deliv-
ery (no physical transport) or the availability or quality of the supply.\textsuperscript{252}
Accordingly, while cross-border supplies traditionally concerned a narrow
range of supplies that were either not available from domestic suppliers or
available abroad at a lower price (including the distance-related transport
costs), this is no longer the case with online supplies that are as easily con-
ducted cross-border as they are conducted domestically. As a consequence,
cross-border transactions in intangibles have dramatically increased.\textsuperscript{253}
While this allows suppliers to serve a global customer base and to provide
customers with a much wider offer, it also has a major impact on suppliers’
collection obligations in destination-based tax systems because it means
that they have to collect and remit value added taxes in a multitude of ju-
risdicitions of consumption, also taking into account the fact that most on-
line suppliers carry out “high-volume, low-value supplies”. In section 2.4.
of chapter 2, we will describe and critically assess the specific collection
mechanisms put in place by the EU legislator to address that issue.

The decentralized nature of the e-marketplace, which first resulted in a
relative disintermediation (i.e. a massive increase of sales directly to the

\textsuperscript{251} On the gravity model of trade, see C. Carrère, Revisiting the effects of regional
trade agreements on trade flows with proper specification of the gravity model, 50 Eu-
ropean Economic Review 2., pp. 223-247 (2006); J.H. Bergstrand, The Gravity Equa-
tion in International Trade: Some Microeconomic Foundations and Empirical Evi-
dence, 67 The Review of Economics and Statistics 3 (2005), pp. 474-481; R.C. Feen-
stra et al., Using the Gravity Equation to Differentiate among Alternative Theories of

\textsuperscript{252} In that sense, see G. Kortenaar & C. Spanjersberg, Taxation and E-Commerce:

\textsuperscript{253} W. Hellerstein, Electronic Commerce and the Challenge for Tax Administra-
tion, World Trade Organization, Committee on Trade and Development, Seminar on
Revenue Implications of E-Commerce for Development, p. 6 (2002).
consumers), eventually led to a new form of centralization via the creation of marketplaces for applications and similar forums, through which online suppliers are able to reach a global customer base in an easier way. The reliance on intermediation (i.e. to one or several intermediaries) and the fact that, as a consequence, online suppliers may not know to whom their supplies are being delivered, raises the question of who should be liable to account for the tax. The new EU VAT Directive provision that entered into force on 1 January 2015 to tackle that question will be analysed and assessed in section 2.6. of chapter 2.

Finally, the question of the characterization of online supplies for tax purposes also arises because online deliveries blur the distinction traditionally made between "goods" and "services". The question bears significant tax consequences since different rules traditionally apply to these categories of supply, e.g. as regards the place where they should be taxed or the applicable rate. In chapter 2 we will analyse and critically assess the definition given by the EU legislator to "electronically supplied services" (and more generally the characterization of online supplies as a subcategory of service under the VAT Directive in section 2.2. in chapter 2), as well as the rule that applies concerning the application of reduced rate to this specific subcategory of supplies and also the consequences of such categorization on the applicable rates (see section 2.5.).

1.3.3. Possible approaches towards taxing online supplies and international initiatives

As signalled above, whereas national legislation often applies indistinctively to activities taking place online and offline, the idea of a "free Internet" – free from any form of government regulation – has traditionally been very popular in the US. This probably impacted on the discussion whether and how to tax the Internet in general and, in 1998, the US federal government adopted a 3-year moratorium on Internet taxes, known as the Internet Tax Freedom Act ("ITFA"). The Act prohibits the levying of

255. See section 1.3.2.
256. The Federal Internet Tax Freedom Act (ITFA, P.L. 105-277, 10/21/98) imposed a 3-year moratorium (from 10/1/98 through 10/21/2001) on state and local taxes on Internet access, unless such tax was generally imposed and actually enforced before
taxes on Internet access and telecommunication services as well as “multiple or discriminatory taxes on e-commerce” but, interestingly, and as will be further discussed in chapter 4, it does not prohibit the levying of taxes on e-commerce activities. In fact, there were attempts to include taxes on online supplies (“digital” supplies or “intangibles” as they are usually referred to in US literature and legislation) in the scope of the moratorium in the early 2000s, but the proposal never received the necessary majority to be adopted.257 Accordingly, it is a misinterpretation of the ITFA (but one that is often made) to argue that online supplies may not be subject to tax as a result of the moratorium.258 Nevertheless, several states have decided (but without being obliged by federal law) to exclude online supplies from their consumption tax scope (see chapter 4).259

A first range of traditional arguments in favour of a tax exemption of online supplies was that the Internet should remain a tax-free zone so as not to impede its development.260 It was, in particular, argued that there were special network externalities proper to the sector that deserved protection, at least in an early stage.261 This infancy industry argument may, however, nowadays have lost much of its force because, as discussed in 1.3.1., e-commerce has rapidly become a flourishing sector and its development has not been impeded by the application of taxes comparable to those that apply to conventional economic activities.262 Analysts also note that arguments

October 1, 1998. This moratorium was subsequently extended to November 1, 2003 (P.L. 107-75; 11/28/01), to November 1, 2007 (P.L. 108-435; 12/3/04) and to November 1, 2014 (P.L. 110-108; 10/31/07).

257. For an overview of the situation until 2004, see D. Sheppard, The Year the Internet Moratorium Came Back from the Grave, 35 State Tax Notes, 847 (2004).


259. As will be discussed, in addition to the fact that online supplies are excluded from the tax base in several US states, other states cannot require the collection of taxes on many online supplies, in accordance with a 1992 decision of the US Supreme Court in Quill Corp. v. North Dakota (504 U.S. 298 (1992)).


regarding externalities are usually based on political rather than economic considerations.263

A second range of arguments in favour of an exemption hinges on the fact that taxing e-commerce would amount to imposing new taxes on consumers.264 This argument is not convincing either, as online supplies constitute economic activities that simply rely on a new medium to reach consumers and conclude transactions.265 In that context, taxing traditional commerce while exempting e-commerce would run counter to the principle of equality.266 This would moreover be in contradiction with traditional economic theories according to which there should be uniformity of taxation across the tax base and comprehensive application of taxes.267 This was clearly acknowledged by the US federal government as early as 1997: “No tax system should discriminate among types of commerce, nor should it create incentives that will change the nature or location of transactions.”268

A third range of arguments in favour of exemption is that consumption taxes on e-commerce would raise too many practical difficulties that are currently not properly tackled. Hargitai, for instance, argued that tax relief should be granted for online supplies because the application of traditional tax rules is not straightforward.269 Svantesson suggested that the slow pace of taxation development can actually not keep pace with the rapid development of technology.270

264. Upon introduction of the S 328 IS (106th Congress) that made the moratorium on new Internet taxes permanent, Senator Bob Smith noted: “A tax on Internet shopping is really just another tax on the American consumer.”
266. R. Van Breda, Sales Taxation (Kluwer 2009), p. 245.
The opposite approach to an exemption was to introduce new taxes on e-commerce and the main suggestion to this effect was to introduce a “bit tax”, under which the data stream flowing over the Internet, rather than the transaction itself, would be taxed.271 This approach never convinced states, essentially because the volume of data flow is difficult to measure accurately and because of the difficulty to ascribe value to the data and to determine what is taxable and what is not. The taxation of all data exchange would indeed not distinguish between high- and low-value products. In addition, it would also cover data such as e-mail and information that are not part of a commercial transaction.272 More important, even if the tax would be technically feasible, it would remain economically and politically undesirable because this approach would amount to imposing a new tax only on e-commerce, which would create distortions of competition to the advantage of conventional supplies, and it would therefore have the potential to stifle one of the more dynamic developments in international trade.

In conclusion, we are convinced neither by the arguments in favour of an exemption nor by the arguments in favour of introducing new taxes on e-commerce, and we share the more pragmatic and widely accepted position that the solution lies in reforming our tax systems. This approach was already advocated by the European Commission as early as 1997 when it concluded that no new or additional tax should be implemented to tackle online supplies because “VAT, as opposed to any new form of tax, is appropriate to electronic commerce, just as it is to more traditional ways of conducting business.”273 The same approach was endorsed by the OECD, which concluded around the same time that traditional forms of taxes should apply to e-commerce.274

---


274. OECD, Ottawa Framework, paras. 4-6 and 9. See also OECD, Electronic Commerce, The Challenges to Tax Authorities and Taxpayers (1997); OECD, Electronic Commerce: A discussion paper on Taxation Issues (OECD Publishing 1998); OECD, Joint Declaration of Business and Government Representatives: Government/Busi-
As already noted, when e-commerce started developing, the international community rapidly sensed the need to adapt traditional regulatory systems to the emergence of e-commerce at a global level. The 1997 Bonn Ministerial Conference supported the idea of cooperation and highlighted that “Conservative application [of existing tax rules] will lead to nonsensical attempts of taxation.”

A 1997 EU-US Summit Joint Statement) agreed that “taxes on electronic commerce should be clear, consistent, neutral and non discriminatory” and committed to continue discussing the topic with a view to reaching consensus in the appropriate multilateral forums, “which may include, for example, the WTO, the OECD, WIPO, and UNCITRAL.”

In 1998, the WTO adopted a “comprehensive Work Programme on electronic commerce”, but, surprisingly perhaps, in view of the explicit prohibition of indirect tax discrimination in articles III of the GATT and XVII of the GATS, WTO members did not engage in discussions concerning the adaptation of their internal tax systems (such as value added taxes) to online supplies.

Unsurprisingly, in view of its leading role in dealing with the international aspects of direct taxes, it was the OECD that prompted its members to adopt a coordinated approach for e-commerce taxation in the late 1990s. In November 1997, OECD members met in Turku (Finland) together with non-members and business representatives, to discuss some basic principles, including the need for e-commerce to be market-driven with minimal government intervention (“as and where needed”). They met again in 1998 in Ottawa (Canada) where they adopted a “government/business joint declaration” and an “Action Plan for Electronic Commerce” endorsed.

---

276. Id.
279. We mentioned the OECD Model Tax Convention on Income and on Capital (see section 1.3.2.).
280. The OECD not only looked at taxation aspects of e-commerce but investigated areas as diverse as consumer and privacy protection, competition, education, development, etc.
by Ministers in Ottawa in 1998,\textsuperscript{283} as well as broad taxation framework conditions, known as the “The Ottawa Framework”, eventually laid down in a report by the OECD Committee of Fiscal Affairs (CFA).\textsuperscript{284} Two sets of implementing guidelines were released in 2001 and 2003 by OECD Working Party 9 (WP9),\textsuperscript{285} based on reports submitted by its two Technical Advisory Groups (TAGs). Also in 2003, the CFA released a Report on Automating Consumption Tax Collection Mechanisms.\textsuperscript{286} 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.\textsuperscript{287} These “OECD recommendations” became the international standard. They were used as a model by the EU legislator when amending its VAT legislation with a view to tackle the development of e-commerce (see chapter 2).

Discussions regarding the implementation of the Ottawa Framework basically stopped since 2003 because the feeling arose that neutrality requires a broader approach to services in general.\textsuperscript{288} For that reason, the CTPA suggested WP9 broaden the focus of its work and cover all cross-border transactions. Two reports were issued in 2004\textsuperscript{289} and 2005\textsuperscript{290} that concluded along the same lines. This convinced the CFA to start a new project to build on the Ottawa Framework principles and its implementing guidelines towards more general guidelines for applying consumption taxes to cross-border transactions for goods, services and intangibles.\textsuperscript{291}

\begin{enumerate}
\item \textsuperscript{284} OECD, Ottawa Framework.
\item \textsuperscript{285} OECD, WP9 2001 Report and OECD, WP9 2003 Report.
\item \textsuperscript{288} OECD, Implementation Issues for Taxation of Electronic Commerce (OECD 2003).
\item \textsuperscript{289} OECD, Report on the Application of Consumption Taxes to the Trade in International Services and Intangibles (2004).
\item \textsuperscript{290} OECD, The Application of Consumption Taxes to the Trade in International Services and Intangibles – Progress Report and Draft Principles (2005).
\item \textsuperscript{291} A. Cockfield et al., Taxing Global Digital Commerce (Kluwer 2013), p. 200 refers to this bottom-up approach.
\end{enumerate}
Chapter 1 - Setting the Scene

This new project was launched in February 2006 with the release of a very basic Draft International VAT/GST Guidelines for “services and intangibles”. In fact, this draft provided for a detailed table of contents, but only the preface, chapter 1 (on basic principles), and part III.C (on electronic commerce) of chapter III (dedicated to the taxation of services in specific sectors) were developed. This basic draft has been overtaken by more fleshed-out draft guidelines for B2B supplies, which were submitted for comments in 2010 and 2013 (which were themselves adopted on the basis of consultation documents). Quite surprisingly, the 2010 and 2013 drafts no longer provided for a separate section for e-commerce transactions, but broadly suggested the application of the approach recommended in the Ottawa Framework and subsequent guidelines for online supplies to conventional services. The OECD Council approved final guidelines for B2B supplies of services and intangibles in April 2014 (still without a specific section on e-commerce). A first draft for discussion on B2C supplies of services and intangibles was released in December 2014, which does not contain a specific section on e-commerce either, but which nevertheless grants more specific attention to the particular difficulties faced by online suppliers for assessing the tax in this new economic environment. More detailed guidelines are expected by the end of 2015.

An interesting development is that the OECD efforts at producing international VAT/GST guidelines are now taking place in the broader context of the OECD Action Plan on Base Erosion and Profit Shifting (BEPS), which was launched at the request of G20 Finance Ministers in the summer of 2013. This Action Plan identifies 15 specific actions that would be
needed in order to equip governments with the domestic and international instruments to address the tax challenges related to “an increasingly interconnected world”. Action 1 of the BEPS focuses on Addressing the Tax Challenges of the Digital Economy (draft delivered in September 2014), but in practice only briefly touches upon the specific challenges that arise in the field of consumption taxes. In fact, the WP9 on Consumption Tax was mandated to take the lead on these aspects. And in practice this is done through its Consumption Tax TAG, which is preparing the draft International OECD/VAT guidelines discussed above.

Summing up, there was thus an emerging consensus in the 1990s that existing taxes should be applied to e-commerce but that more work was required on the key question of how to impose a tax on online supplies or, in other words, the question to what extent traditional tax systems, such as VAT, needed to be reformed so that they could be imposed and collected efficiently on supplies that no longer are made at a certain place where a buyer and a seller meet to physically transfer a product or a service. The only international reply to that question has come in the form of the OECD recommendations, which are summarized in the following section.

1.4. The OECD recommendations as the international standard

Countries around the world have traditionally gone their own way in taxation, particularly in the area of VAT (except in the EU, where harmonization is ongoing since the late 1960s). The global nature of e-commerce, however, makes international cooperation indispensable and some players, including, in particular, the European Commission, predicted early on...
that taxing e-commerce would require a significant effort in policy harmonization from international forums.\textsuperscript{304}

As mentioned already, it was the OECD that prompted its members to discuss the difficulties related to the taxation of e-commerce transactions and to adopt a coordinated response, which eventually took the form of “recommendations”, consisting of the 1998 Ottawa Framework by the CFA and of Implementing Guidelines by the CFA, WP9 and the CTPA.

In short, the twofold objective of the 1998 Ottawa Framework was to set up a fiscal climate that would, first, allow e-commerce to flourish and, second, be fair and predictable for its users (points 1 and 2 of the 1998 Ottawa Framework). The CFA drew a number of main conclusions, including on taxpayer service, on applying existing principles while recognizing that new rules may be required and on further cooperation and consultation with business.

On taxpayer service (points 3 and 8, Box 1, and point i of Boxes 3 and 4 of the 1998 Ottawa Framework) the CFA concludes that revenue authorities should use opportunities to improve service standards (enhanced communication and access to information to assist taxpayers and improve response times), minimize compliance costs (by means of simplified registration and filing requirements and norms for the acceptance of electronic material) and to enhance voluntary compliance (through electronic assessment and collection and easier, quicker and more secure ways of paying tax and obtaining refunds). As a concrete post-Ottawa step the CFA suggests developing international consensus on ways to simplify tax systems so as to minimize compliance costs, particularly for SMEs.

On existing taxation principles and possible new measures (points 4 to 6 and 9 to 14, and Boxes 2 and 3 of the 1998 Ottawa Framework) the CFA first recommends that existing principles\textsuperscript{305} should guide governments...
The OECD recommendations as the international standard

also in relation to e-commerce. Therefore, under the principle of neutrality, “taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce.” In addition, “business decisions should be motivated by economic rather than tax considerations” and “taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.” Under the principle of efficiency, "Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible."\(^{306}\) Under the principle of fairness and effectiveness, “Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping countenancing measures proportionate to the risks involved.”\(^{307}\) Under the principle of certainty and simplicity, “The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.” Finally, under the principle of flexibility, “The systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.”\(^{308}\)

Nevertheless, the CFA recognizes that new administrative and legislative measures should not be excluded (points 5, 6 and 11 to 14, and Box 3 of

\(^{306}\) As regards private sector compliance and public sector administrative burdens, Smith referred to “convenience” (compliance should be easy) and “economy” (assessment and collection costs should be low) (A. Smith, An Inquiry into the Nature and Causes of the Wealth of Nations, (Hackett, selected edn, 1993). Meade refers to “simplicity and costs of administration and compliance” (J. Meade, The Structure and Reform of Direct Taxation (IFS 1978)).


\(^{308}\) Certainty, simplicity and flexibility are often mentioned together. Smith (A. Smith, An Inquiry into the Nature and Causes of the Wealth of Nations, (Hackett, selected edn, 1993)) felt that taxes should be imposed in a transparent and non-arbitrary manner (certainty), but Meade (J. Meade, The Structure and Reform of Direct Taxation (IFS, 1978)) was more nuanced and recognized that some stability is necessary to allow taxpayers to make forward plans, while also insisting that it should be possible to adjust tax burdens and tax policy objectives (flexibility and stability).
the 1998 Ottawa Framework). However, new measures should help apply existing principles, they should not cause a discriminatory tax treatment of e-commerce and they should also help maintain fiscal sovereignty and a fair sharing of the tax base while avoiding double taxation or unintentional non-taxation.309

It is under these broad conclusions (on applying existing principles while recognizing the need for new rules) that the CFA recommends a number of elements of a taxation framework for e-commerce in particular,310 including the following elements for consumption taxes on online supplies:311

– **Destination-based taxation:** Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction. As a concrete post-Ottawa step, the CFA suggests reaching agreement on, inter alia, defining place of consumption, on place of taxation rules and on internationally compatible definitions of services and intangible property (Box 4 point vi).

– **Online supplies are not supplies of goods:** For the purpose of consumption taxes, the supply of digitized products should not be treated as a supply of goods (Box 3 point v).

– **Reverse charge for B2B:** Where business and other organizations within a country acquire services and intangible property from suppliers outside the country, countries should examine the use of reverse charge, self-assessment or other equivalent mechanisms where this

---

309. Points ii to iv of Box 3 advise tax authorities to maintain their ability to obtain required information (i.e. to identify taxpayers and to administer their tax systems), to ensure that appropriate collection and control systems are in place and develop international collection assistance. Points ii to v of Box 4 identify post-Ottawa steps, including the adoption of conventional identification practices for e-commerce businesses, development of international guidelines on digital signatures, development of international information requirements (acceptance of electronic records, their format and access arrangements) and development of measures to improve compliance with regard to e-commerce transactions. More in general the CFA suggests developing options, post-Ottawa, for ensuring the continued effective administration and collection of consumption taxes as electronic commerce develops (Box 4, point vii).

310. Box 3 makes recommendations on a variety of topics that will not be further discussed, including taxpayer service, the information needs of tax administrations, tax collection and control, and international cooperation including clarification of the OECD Model Tax Convention.

311. Box 3 points v to viii relate to consumption taxes, of which points v to vii relate to online supplies and point viii relates to imports of physical goods (the latter will not be further discussed).
The OECD recommendations as the international standard

would give immediate protection of their revenue base and of the competitiveness of domestic suppliers (Box 3 point vii).

Finally, the CFA notes that intensified post-Ottawa cooperation and consultation with business is important (paragraphs 7, 15 and 16, Box 3 point ix, and Boxes 4 and 5 of the 1998 Ottawa Framework).

Different forums have been set up for the implementation of this 1998 Ottawa Framework. The CFA adopted a consolidated work programme on electronic commerce and, in this context, a work programme on consumption tax aspects of electronic commerce was established by its WP9. Subsequently, WP9 created a subgroup on electronic commerce, which focused on the practical application of the principle of taxation in the place of consumption, the analysis of different tax collection mechanisms and the examination of the possibilities for taxpayer and consumer identification, access to information and administrative simplification. WP9 then adopted two reports, respectively in 2001 and 2003 (hereinafter respectively the “WP9 2001 report” and “WP9 2003 report”).

Interestingly, WP9 benefited from the input of two TAGs (already mentioned above). The first considered tax policy and administrative issues (Consumption Tax TAG), the other advised on technology issues (Technology TAG). The TAGs were composed of government and industry representatives. The Consumption Tax TAG’s mandate was to advise on tax collection, tax compliance and tax policy issues. It functioned “predominantly as a mechanism for identifying business concerns and priorities”. As a consequence, its reports principally reflect business thinking, although it seems to have “helpfully identified a good deal of common grounds between business and government”.

---

313. Members include Australia, Canada (Chair), France, Germany, Ireland, Italy, Japan, Korea, Norway, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States, the European Commission and Singapore.
316. Other TAGs provided input for the application of direct taxes: Treaty Characterisation TAG, Business Profit TAG and Professional Data Assessment TAG. See OECD, WP9 2003 Report.
318. OECD, Consumption Tax TAG 2000 Report, p. 3.
Chapter 1 - Setting the Scene

that of a responsive expert group providing input on the implementability of technological solutions to issues of audit, tracking and collection (including feasibility, reliability, cost, efficacy and commercial reasonability). The Technology TAG was therefore less “business-oriented” than the Consumption Tax TAG. Importantly, even though the TAGs provided extensive guidance to WP9, and whereas the Ottawa Framework insisted on the importance of consulting businesses in this field (as noted above), the TAGs were not vested with any decision-making powers and in practice, as will be discussed in chapter 2, the WP9 reports sometimes deviate significantly from the suggestions made in the TAGs’ reports.

Further guidelines were then adopted by the CFA and the CTPA. The substance of the WP9 and TAG Reports and of the CFA and CTPA guidelines (together the “Implementing Guidelines”), which have inspired the EU legislator for the amendment of its VAT legislation, will be analysed and discussed, where relevant, in chapter 2. The broader guidelines recently adopted for B2B supplies of services and intangibles and those that are still under work concerning B2C supplies of services and intangibles will be discussed in chapter 4.

An important clarification is that the OECD recommendations are not binding. It is actually noteworthy that the WP9 2001 report has been endorsed by the CFA, but not by the OECD Ministerial Council, and that the WP9 2003 report has not even been endorsed by the CFA. They, however, benefit from a certain authority, in view of the role and influence of the OECD in the field of international tax coordination. As a matter of fact, although not formally deciding on tax policies, the OECD managed in the last decades to project itself as an (informal but yet efficient) “world tax organization” which prompted the achievement of a series of reforms giving rise to effective tax cooperation at the international level. In fact, consensus on the role of the OECD in international tax coordination developed quite naturally from the recognition that double taxation can be an impediment to trade and that the OECD is fostering trade and economic development. In practice, the OECD efforts have resulted in the produc-


The OECD recommendations as the international standard

tion of (non-binding) standards, models, recommendations and guidelines, consisting of principles and best practices that should subsequently be implemented by governments (including by means of international agreements). The well-known OECD Model Tax Convention (for income taxes), for instance, is used by many countries in their negotiations of bilateral tax treaties and is a perfect example of an instrument that initially constituted mere soft law but that subsequently turned into a quasi-binding instrument. Another example are the Transfer Pricing Guidelines, which basically are little more than a commentary on a number of the Model tax treaty articles but which, in practice, are much more influential and have developed as a basis for practice and jurisprudence.

The OECD so far mostly focused on direct taxes. As a result, there is no Model Tax Treaty in the field of value added tax. Unfortunately also, the recommendations on e-commerce indirect taxation (which were the first recommendations that the OECD ever issued in the field of indirect taxes) have not yet resulted in the adoption of any bilateral agreements. But the authority and influence of the OECD’s work in the field of indirect taxation are likely to increase in the coming years. The organization held the two first “Global VAT Forums” in November 2012 (in Paris) and in April 2014 (in Tokyo), with the clear intention to prompt coordination of VAT/GST tax policies among its members and beyond. The Draft International VAT/GST Guidelines for the taxation of goods (not yet drafted) and of services and intangibles (see section 1.3., guidelines for B2B supplies have been adopted by the OECD Council at the Tokyo meeting in April 2014 and guidelines for B2C supplies are under work) is a major tool to that effect. The mandate given to the OECD Working Party 9 in the context of the BEPS Project also shows the trust placed in the OECD by G20 members, and therefore also its authority, to tackle the delicate issue of e-commerce consumption taxation.

In any case, and notwithstanding the non-binding nature of the OECD recommendations, the EU legislator rapidly introduced specific provisions dedicated to “electronically supplied services” in its VAT legislation that are modelled on these recommendations and that apply on a harmonized basis in the 28 Member States. As indicated in section 1.1., the objective of this study is to assess these provisions, on the one hand, from the viewpoint of their feasibility and compliance with the OECD recommendations (see

321. OECD Model Tax Convention on Income and on Capital. The OECD Model is regularly cited by the European Court in its income tax case law; e.g. see Gilly (Case C-336/96).
chapter 2) and, on the other hand, from the perspective of their compliance with the principle of non-discrimination (see chapter 3) before making proposals for reform (see chapter 4).