



EUROPEAN COMMISSION

Brussels, 1.12.2010
COM(2010) 695 final

GREEN PAPER

On the future of VAT

Towards a simpler, more robust and efficient VAT system

{SEC(2010) 1455 final}

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1. INTRODUCTION

Value added tax (VAT) was first introduced in Europe in 1954, in France. In 1967, the Member States of the European Economic Community, as it was then, agreed to replace their national turnover tax systems with a common VAT system. Since then, VAT has been introduced in around 140¹ countries worldwide.

By 2008 VAT receipts accounted for 21.4% of the national tax revenues of EU Member States (including social security contributions), a rise of 12% since 1995². It is thus a major source of revenue for national budgets and in many Member States it is the main source. VAT receipts represented in 2008 on average 7.8% of the GDP of a Member State, a figure that has increased by almost 13% from 1995.

The financial and economic crisis has resulted in severe challenges for public finances in many Member States. Given the particular slump in direct and property-related taxes since the recent recession, the share of VAT revenues as part of total receipts has likely grown further in many Member States.

Several Member States have recently increased VAT rates or are considering it, either as a reaction to the consolidation needs resulting from the crisis or in the context of a longer-term shift towards indirect rather than direct taxation. The latter shift can be rationalised by the relative efficiency of consumption taxes, consumption being a broader and more stable base than profits and incomes. The broader base allows for lower rates, thereby reducing the distortive effects of taxation, with favourable effects on growth and employment.

Moreover, given the impact of ageing societies on labour markets, savings and consumption patterns and public expenditure in the years to come, taxation systems will have to be adapted. The financing of the welfare state may have to rely less on labour taxes and tax revenues from capital income (savings), thereby further arguing in favour of a shift to indirect taxation.

After some 40 years, the time has come to have a critical look at the VAT system with a view to strengthening its coherence with the single market, its capacity as a revenue raiser by improving its economic efficiency and robustness, and its contribution to other policies whilst reducing the cost of compliance and of collection. In this way, reforming the VAT system can play a crucial role supporting

¹ OECD, *Consumption Tax Trends 2008, VAT/GST and excise rates, trends and administrative issues*, p. 23.

² *Taxation trends in the European Union*, 2010 Edition, Annex A, Tables 7 and 8.

the delivery of the Europe 2020 strategy³ and a return to growth through its potential to reinvigorate the single market and underpin smart budget consolidation in the Member States. Any such improvements require a comprehensive VAT system that can adapt to changes in the economic and technological environment and is solid enough to resist attacks of fraud of the kind experienced in recent years.

A simpler VAT system would also reduce the operational cost to taxpayers and tax administrations, thereby increasing the net benefit to the Treasury.

Moreover, the key role of businesses in collecting VAT must be properly recognised, since VAT is a consumption tax and not a tax on businesses. VAT compliance costs are a major administrative burden for EU business and reducing this burden would contribute significantly to increasing the competitiveness of European companies.

These are the main challenges the EU is facing in the field of VAT. Moreover, they have to be met in the unique context of a single market guaranteeing free movement of goods and services between Member States, as established in 1993 with the abolition within the EU of fiscal controls at the border.

The objective of this Green Paper is to launch a broad based consultation process with stakeholders on the functioning of the current VAT system and how it should be reframed in the future.

2. WHY LAUNCH A DEBATE ON THE VAT SYSTEM NOW?

The approach followed in the last decade has been to simplify and modernise the current VAT system by increments. It has produced positive results, although it has reached its limits.

There are also a number of factors indicating that the time is now right for broader reflection.

2.1. The complexity of the current system

The complexity in the VAT rules results in administrative burdens for businesses. Dealing with VAT accounts for almost 60% of the total burden measured for 13 priority areas identified under the *Better Regulation Agenda*⁴. According to business, this is making the EU a less attractive place to invest⁵.

Particular areas of concerns include key elements in the system such as obligations, deduction and rates. These can be particularly severe for SMEs which cannot always afford tax expertise to deal with increasingly complex VAT rules.

³ COM(2010) 2020, 3.3.2010, *Europe 2020: a strategy for smart, sustainable and inclusive growth*.

⁴ COM(2009) 544, 22.10.2009, *Action Programme for Reducing Administrative Burdens in the EU Sectoral Reduction Plans and 2009 Actions*, Measurement studies: http://ec.europa.eu/enterprise/policies/better-regulation/documents/ab_studies_2009_en.htm

⁵ Position Paper of 20 October 2009 on a partnership for a fair and efficient VAT system from *BusinessEurope*.

2.2. Making the single market work better

The fact that domestic and intra-EU⁶ transactions continue to be treated differently for VAT purposes may be an obstacle to the better functioning of the single market. This is compounded by the existence of numerous options and derogations for Member States under EU VAT law which leads to divergent rules across the EU.

The vital importance of a stronger, deeper, extended single market is highlighted in the Commission's Communication *Europe 2020: a strategy for smart, sustainable and inclusive growth*. Reforming the VAT rules in a 'single market-friendly way' was one of the recommendations made in a report presented at Commission President José Manuel Barroso's request by Professor Mario Monti in May 2010, outlining a comprehensive strategy for re-launching the single market⁷.

The *Single Market Act* sets out several initiatives including creating a supportive legal and fiscal environment for business in order to reduce administrative burdens and promote cross-border activity. VAT is a key element in this respect⁸.

2.3. Maximising revenue collection and tackling the system's susceptibility to fraud

A broad based VAT system, ideally with a single rate, would be quite close to the ideal of a pure consumption tax that minimises compliance costs. However, in the EU, the standard rate covers only about two thirds of total consumption, with the remaining one third subject to different exemptions or reduced rates⁹. Of the EU Member States that are also members of the OECD, actual VAT revenues represent only 55% on average of the revenues that would, in theory, be collected if all final consumption was taxed at the standard rate. Other OECD countries such as Japan, South Korea or Switzerland have a more efficient VAT system with ratios of around 73%¹⁰.

In 2008, total VAT receipts collected by the Member States came to around EUR 862 billion. A study¹¹ has estimated the EU VAT gap (the difference between actual VAT receipts and what the Member States should theoretically receive based on their economies) at 12% of theoretical VAT receipts in 2006, with several Member States above 20%. Besides tax avoidance and losses due to insolvencies, the VAT gap is attributable also to fraud resulting in part from the endemic weaknesses of the current provisions, which, in particular, allow VAT-free cross-border purchases of goods and services.

⁶ We use the term 'intra-EU' here because, with the entry into force of the Lisbon Treaty, the term 'intra-Community' as commonly used and defined in VAT legislation, should no longer be used. The meaning is the same.

⁷ *A new strategy for the single market: at the service of Europe's economy and society*, http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf.

⁸ COM(2010) 608, 27.10.2010.

⁹ Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union*, Final Report, 21.6.2007.

¹⁰ OECD, op. cit., p. 69.

¹¹ *Study to quantify and analyse the VAT gap in the EU-25 Member States*, carried out by Reckon LLP on behalf of the Commission.

2.4. Changes in technology and the economic environment

The EU's VAT system has evolved slowly compared with the technological and economic environment, which has seen rapidly changing business models, increasing use of new technologies, the growing importance of services - now accounting for about 70% of economic activity - and globalisation of the economy generally.

However, these technological changes may as well offer the possibility of new and alternative ways of collecting VAT to reduce burdens on business and VAT losses. The existing collection model has remained substantially unchanged since the introduction of VAT.

3. QUESTIONS TO BE ADDRESSED

Discussions on the future of VAT have been divided between two major headings.

The first of these concerns the principles of taxation of intra-EU transactions on which an EU VAT system, fully adapted to the single market, should be based. The second covers issues which need attention irrespective of any choice to be made on the treatment of intra-EU transactions.

A more thorough and technically detailed discussion of a number of topics touched upon in the present paper can be found in a Commission Staff Working Document available at http://ec.europa.eu/taxation_customs/index_en.htm.

4. VAT TREATMENT OF CROSS-BORDER TRANSACTIONS IN THE SINGLE MARKET

4.1. Implementing the definitive arrangements based on taxation at origin

From the first legislation on VAT agreed upon at EU level, a commitment was taken for the introduction of a VAT system tailored to the single market and operated across Member States in the same way as within a single country.

The VAT Directive¹² still stipulates that the current arrangements for taxation of trade between Member States are transitional and shall be replaced by definitive arrangements based in principle on the taxation of goods and services in the Member State of origin.

However, an attempt made in 1987 to honour this commitment based on the physical flow of goods was unsuccessful. An alternative proposal in 1996 based on the place of establishment of the supplier was equally unsuccessful.

The ostensible reasons why taxation at origin has not proven acceptable so far are as follows:

- Close harmonisation of VAT rates would be needed to prevent rate differences from influencing decisions on where to buy, not just for private individuals but also for businesses as the payment of VAT - although eventually deductible -

¹² Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

affects their cash-flow. It should be pointed out, however, that in recent years a certain convergence of the standard VAT rates has been ongoing;

- A clearing system would be needed to ensure that VAT receipts accrue to the Member State of consumption. New information technologies - not available at the time of the earlier discussions - have the potential to overcome this obstacle;
- Member States would have to rely on each other to collect a substantial part of their VAT revenue.

In June 2007 the Council invited, in the context of the debate on combating VAT fraud, the Commission to explore again a VAT system based on taxation at departure of the goods.

To overcome the issue of differences in VAT rates, the Commission analysed a model in which intra-EU supplies to taxable persons would be taxed at 15 % with the Member State of destination either collecting the additional VAT from the customer to reach the applicable rate or refunding the VAT paid in excess.

The Council however did not respond to the Commission's request for a positive show of interest needed before embarking on a more in-depth analysis of such a regime.

In the meantime, new Directives laying down the place of taxation for certain transactions¹³ have clearly moved away from the principle of taxation in the Member State of origin by stipulating the place of taxation as the place where consumption occurs or where the customer is established.

4.2. The alternative route: taxation in the Member State of destination

The main feature of taxation at destination is that VAT revenues accrue directly to the Member State of consumption, according to its domestic rates and exemptions, thereby resolving the main objections against taxation at the place of origin.

A major issue to be resolved in such a system, however, is ensuring that the treatment of intra-EU supplies and domestic supplies is consistent. Equal treatment can be achieved either by taxing intra-EU supplies or by eliminating the effective charging of VAT on domestic transactions via a generalised reverse charge system (whereby the taxable person to whom the supply is made becomes the person liable for the payment of VAT). However, another question is whether treatment actually needs to be equal and, if it does not, to what extent a different treatment is acceptable, without it being an obstacle to the smooth functioning of the single market or allowing fraud linked to cross-border transactions.

¹³ Electronically supplied services provided from third countries to EU private individuals (Directive 2002/38/EC), supplies of electricity and natural gas (Directive 2003/92/EC), supplies of services (Directive 2008/8/EC).

4.2.1. *Maintaining the principles of the current system*

The current VAT system makes a distinction between supplies between taxable persons (business to business or ‘B2B’) and supplies to final consumers (business to consumer or ‘B2C’).

For cross-border B2B transactions, the general principle, both for goods and services, is taxation at the rate and conditions of the Member State of destination (where the goods arrive or, for services, where the customer’s business is established) with the customer paying the VAT to the Treasury. This results in supplies of goods and services being treated differently depending on whether they are domestic or intra-EU. This distinction is a source of complexity and of vulnerability to fraud.

B2C supplies are normally taxed in the Member State where the sale of goods is made or where the supplier is established. However, because of the risk of distortion of competition, special arrangements apply to the taxation of the supplies at destination, imposing heavy obligations on suppliers (distance sales of goods or certain services) or purchasers (purchases made by exempt taxable persons, notably small businesses, or non-taxable legal entities, and purchases of new means of transport, for example).

Nevertheless, the system has merits. For Member States it guarantees a degree of policy freedom and fiscal sovereignty in administering VAT. For business customers of B2B cross-border transactions, it does not seem to create huge VAT problems and might even have some advantages since the VAT does not need to be pre-financed.

The burden falls mainly on the supplier, who, in his or her Member State, must justify exemption (in supplying goods) or non-taxation (for services) and faces certain additional reporting obligations and, increasingly, more stringent formalities designed to tackle fraud: the ‘red tape’ involved in cross-border transactions has been steadily increasing. In addition, tax administrations may challenge exemption or non-taxation if fraud has occurred elsewhere in the commercial chain and legitimate businesses may find it difficult to protect themselves against that risk.

Maintaining the fundamentals of the current VAT regime would require an in-depth review and improvement of its application in terms of legal certainty and administrative burdens on intra-EU transactions.

4.2.2. *General use of the ‘reverse charge’ mechanism*

Consistency between domestic and intra-EU transactions could be achieved by applying a reverse charge mechanism on domestic B2B transactions. This would deal with the endemic vulnerability to fraud of the current VAT system. On the other hand, it would require additional checks and reporting obligations for domestic transactions in order to limit the fraud shifting to the retail level as it would mean discarding the principle of ‘fractioned payment’, which is regarded as a major benefit of VAT.

The Commission studied the system in 2008¹⁴. It concluded that the reverse charge concept should not be ruled out but that it could never be introduced on an optional basis without affecting the workings of the single market. The Commission was willing to consider a pilot project to test the introduction of a compulsory generalised reverse charge system. While maintaining its position, the Commission is well aware of the administrative and economic implications of such a project.

4.2.3. *Taxation of intra-EU supplies of goods and services*

Consistency between domestic and intra-EU transactions could also be achieved by taxing intra-EU transactions at the rate and under the rules of the Member State of destination.

This would restore the principle of fractioned payment for cross-border transactions and deal with the current system's endemic vulnerability to fraud. On the other hand, it would substantially increase the number of transactions for which taxable persons become liable for VAT in a Member State in which they are not established.

When taxing intra-EU supplies, the place of destination can be defined in two ways:

- as the place of arrival, for goods, meaning the physical flow of the goods would still be followed, and as the customer's place of establishment, for services, which is already the main rule at present;
- as the customer's place of establishment, for both goods and services.

Because VAT on intra-EU supplies would accrue to the Member State of destination, an effective one-stop-shop mechanism in the Member State of origin would be needed to deal with VAT liabilities in Member States other than those in which the supplier is established.

Such a change would have consequences for businesses and tax administrations. Taxation of intra-EU supplies would have cash-flow implications for both parties and reporting obligations would have to be completely reviewed. The Commission has not yet carried out a detailed analysis of such arrangements but remains open to further explore these options.

4.3. **Other variants**

The Commission is aware that other arrangements besides those described above have been discussed in the public domain. It is not the intention to discard them from the discussion but, because most of them look like merely variants, there is no need to go into them in depth at this stage.

Q1. Do you think that the current VAT arrangements for intra-EU trade are suitable enough for the single market or are they an obstacle to maximising its benefits?

¹⁴ COM(2008) 109, 22.2.2008 and SEC(2008) 249, 22.2.2008.

Q2. If the latter, what would you consider the most suitable VAT arrangements for intra-EU supplies? In particular, do you think that taxation in the Member State of origin is still a relevant and achievable objective?

5. OTHER KEY ISSUES TO BE TACKLED

This section covers the major issues which need to be addressed, in addition to the treatment of intra-EU transactions, to establish a solid, simpler and more efficient VAT system for the single market. These questions apply to the current system.

5.1. How to ensure the neutrality of the VAT system

5.1.1. *The scope of VAT*

The rules applying to public bodies create differences in the VAT treatment of similar activities depending on the status of the supplier. The evolution in the Member States towards privatisation and the deregulation of activities traditionally reserved for the public sector has increased these differences. New forms of cooperation between public authorities and the private sector (public-private partnerships) have arisen to deliver infrastructure and strategic public services such as roads, railways, schools, hospitals, prisons and water and waste treatment.

Where public bodies are exempt or outside the scope of VAT, they have an incentive to limit outsourcing in order to avoid paying VAT that they cannot deduct. VAT thus becomes a factor influencing investment and spending decisions.

The Commission recently launched a study of the economic and social impact of VAT on public bodies and on possible solutions. One way forward could be to include all the economic activities of public bodies in the scope of VAT and to draw up a list of those activities to be excluded. An alternative would be to clarify and modernise the conditions under which public bodies can no longer be considered to be outside the scope of VAT.

Regarding the VAT treatment of holding companies' transactions related notably to management of shares or treasury functions, the European Court of Justice has provided some limited guidance but it is still difficult to apply in practice. Clarifying the legal situation in the VAT Directive could be an option.

Q3. Do you think that the current VAT rules for public authorities and holding companies are acceptable, particularly in terms of tax neutrality, and if not, why not?

Q4. What other problems have you encountered in relation to the scope of VAT?

Q5. What should be done to overcome these problems?

5.1.2. *Exemptions from VAT*

Exemptions are contrary to the principle of VAT as a broad based tax. The continued relevance of many of the existing exemptions is questionable. Broadening the tax base by reducing the number of exemptions makes the tax more efficient and more neutral and offers a valid alternative to increasing VAT rates.

The VAT Directive distinguishes between exemptions for certain activities in the public interest (e.g. for social, educational and cultural reasons) and exemption for other activities, e.g. because of technical concerns about applying VAT to the underlying transactions (financial services and gambling activities) or interference with other taxes (transactions related to immovable property).

There is a need to review these exemptions, notably in the light of economic and technological changes.

This approach is also relevant for those exemptions which Member States can continue to apply because they already applied them on 1 January 1978 or at the time of their accession. An example is the fact that passenger transport services can continue to be exempt, depending on the means of transport used. Other derogations allow Member States to charge VAT on transactions that would otherwise be exempt. This weakens the objective of a common VAT system.

As regards exemptions in the postal services proposal and the financial and insurance services proposals¹⁵, discussions are still ongoing. Finally, the study on public bodies (see point 5.1.1, paragraph 3) will also address exemptions in the public interest.

Q6. Which of the current VAT exemptions should no longer be kept? Please explain why you consider them problematic. Are there any exemptions which should be kept and, if so, why?

Q7. Do you think that the current system of taxation of passenger transport creates problems either in terms of tax neutrality or for other reasons? Should VAT be applied to passenger transport irrespective of the means of transport used?

Q8. What should be done to overcome these problems?

5.1.3. *Deductions*

The right to deduct input VAT is fundamental to ensuring that the tax is neutral for businesses. The extent to which VAT is deductible is the key factor, but other factors include when and how VAT should be deducted.

To be neutral, VAT on goods and services that are used for taxed economic activities must be fully deductible. It can be difficult to achieve this, and thereby offer a level playing field for businesses across the EU, in cases where goods or services are used for multiple purposes (taxed activities, exempt activities or non-business purposes) and changes in this use occur during the economic lifetime of the goods or services.

Restrictions on the right to deduct are necessary where goods or services are also used for non-business purposes (mainly private consumption). Flat-rate restrictions may solve the problem where the ratio of business to private use is difficult or even impossible to determine, but they should be consistent with the economic reality rather than a means of generating additional revenue.

¹⁵ COM(2003) 234, 5.5.2003, COM (2007) 746, 28.11.2007.

The right to deduct arises when the supply is made, whether or not the customer has paid for the goods or services. This rule may create a cash-flow advantage for late payers in particular, while the burden is borne by suppliers, typically SMEs. Basing the VAT system on payments (cash accounting), so that the VAT becomes chargeable and deductible when the supply is paid would be neutral for everyone in terms of cash flow. Such a system would also limit VAT losses due to customer insolvency.

As a rule, VAT is deducted by offsetting the deductible VAT against the VAT due. Where this means that the taxable person is entitled to a repayment, tax administrations have different approaches, as repayments present some risk of fraud. This risk should not be used as a reason for unduly delaying the right of deduction.

In addition, refund schemes for businesses established in a different Member State complicate and delay the actual deduction of VAT. A one-stop-shop mechanism, whereby they could offset the input VAT incurred in a Member State against the VAT due there, could be a solution.

Q9. What do you consider to be the main problems with the right of deduction?

Q10. What changes would you like to see to improve the neutrality and fairness of the rules on deduction of input VAT?

5.1.4. *International services*

The growing importance of international services, as a result of globalisation, deregulation and developments in communication technology, has clear implications for VAT. Internationally agreed approaches are needed to avoid double or non-taxation of these services and important work is being done on this in the OECD.

However, beyond ensuring legal certainty on taxation in the country of consumption, there are issues to do with checking that VAT is correctly applied. This is particularly the case for electronically supplied B2C services such as software or music distributed online, for which VAT collection is particularly reliant on voluntary compliance by non-EU suppliers. It is questionable whether this is acceptable from a neutrality and competition perspective for EU suppliers and Member States' budgets in the long term.

Encouraging tax authorities to cooperate on VAT at international level is one avenue to explore. The alternative, less attractive at first sight but under consideration in certain non-EU jurisdictions such as Canada, is to seek ways of collecting VAT from private consumers, for example by checking online payments.

There are also concerns about neutrality and transparency in the treatment of supplies of services within international business groups, which varies according to the structure chosen (branch/head office or parent company/subsidiary) rather than the nature of the service.

Q11. What are the main problems with the current VAT rules for international services, in terms of competition and tax neutrality or other factors?

Q12. What should be done to overcome these problems? Do you think that more coordination is needed at international level?

5.2. What degree of harmonisation does the single market require?

Any rethink of the VAT system must identify, on the one hand, the extent to which further harmonisation is essential in order to improve the functioning of single market and reduce compliance costs for businesses and, on the other hand, the degree of flexibility needed by the Member States that is compatible with these objectives.

5.2.1. *The legal process*

The legal base for the harmonisation of VAT¹⁶ requires unanimity but does not specify the legal instrument to be used for that purpose. The use of Council directives gives Member States some freedom in transposing EU VAT law into their national legislation, taking account of their legal particularities. The outcome, however, is often that VAT legislation in the different Member States is inconsistent. Using Council regulations rather than directives would achieve greater harmonisation, enabling in particular the EU to avoid double or non-taxation or to set out the VAT obligations of non-established businesses.

EU measures implementing the VAT Directive also have to be agreed by unanimity. The use of this mechanism (via a Council Regulation) for clarifying new amendments to the VAT Directive quickly before their entry into force has not proven effective. The result is that businesses often lack guidance on the practical application of the new rules.

One answer would be to allow the Commission to adopt Implementing Decisions with the consent of the majority of Member States. The Commission made such a proposal in the past¹⁷, which would have changed the role of the VAT Committee, but was not upheld in the Council.

This problem could also be addressed, albeit in an imperfect, alternative way, by having the Commission provide explanations, for information purposes, on how changes in the VAT law are to be understood.

Incorrect transposition of amendments to the VAT Directive can of course be tackled by launching infringement procedures. But this does not always provide a prompt solution to the practical problems that businesses face. Transposing the new rules well in advance of their entry into force could prevent these problems. A process of streamlining and coordinating the national implementation process at EU level could be envisaged.

Q13. Which, if any, provisions of EU VAT law should be laid down in a Council regulation instead of a directive?

Q14. Do you consider that implementing rules should be laid down in a Commission decision?

¹⁶ Article 113 of the Treaty on the Functioning of the European Union (TFEU).
¹⁷ COM(97) 325, 25.6.1997.

Q15. If this is not achievable, might guidance on new EU VAT legislation be useful even if it is not legally binding on the Member States? Do you see any disadvantages to issuing such guidance?

Q16. More broadly, what should be done to improve the legislative process, its transparency and the role of stakeholders in the process, from the initial phase (drafting the proposal) to the final phase (national implementation)?

5.2.2. *Derogations and the ability of the EU to react quickly*

Member States can seek individual derogations in order to simplify the procedure for collecting VAT or to prevent certain forms of tax evasion or avoidance by means of specific measures, which are intended to be temporary and tailored to a particular domestic situation¹⁸.

The result, however, is a patchwork of particular and changing rules in the Member States which adds to the complexity of the VAT system, especially for businesses operating in more than one Member State, and undermines the notion of a level playing field for EU businesses.

Moreover, recent experience with organised fraud schemes has been that the procedure for granting derogations is not always flexible enough to ensure a prompt and suitable reaction. Granting the Commission more powers to decide at very short notice on protective and temporary derogations to act against fraud upon a duly justified request from a Member State could be a way forward.

Q17. Have you encountered difficulties as a result of derogations granted to Member States? Please describe these difficulties.

Q18. Do you think that the current procedure for granting individual derogations is satisfactory and, if not, how could it be improved?

5.2.3. *VAT rates*

The 'definitive' VAT system based on taxation at origin would require a higher degree of harmonisation of VAT rates compared to the current system based on taxation at destination, which provides Member States with more flexibility still within the limits set by the single market requirements.

It has been argued that the application of a single VAT rate to all goods or services would be an ideal solution from the point of view of maximising economic efficiency¹⁹. At the same time, the use of reduced rates as a policy instrument is often advocated notably for health, cultural and environmental reasons to provide easier

¹⁸ The list of current derogations is available at http://ec.europa.eu/taxation_customs/taxation/vat/key_documents/table_derogations/index_en.htm

¹⁹ Copenhagen Economics, op. cit.

and more equal access to educational and cultural content and incentives for eco-innovation and knowledge-based resource efficient growth²⁰.

The current variation in the standard rate in the EU and the reduced rates applied by some Member States do not seem to disrupt the single market. This is mainly because there are correction mechanisms (special schemes for distance sales of goods or services and new vehicles, see point 4.2.1) in the current VAT system, but these add substantially to its complexity.

Cross-border transactions involving goods and services at a reduced rate do, however, create compliance costs and legal uncertainty for business. This is particularly a problem when a business becomes liable for VAT in a Member State in which it is not established. More transparency, with a binding online database of goods and services under a reduced rate could be envisaged.

Moreover, there are still inconsistencies in the VAT rates applied to comparable products or services. For instance, Member States may apply a reduced VAT rate to certain cultural products but have to apply the standard rate to competing on-line services such as e-books and newspapers. The 'Digital Agenda for Europe'²¹ stipulates that the challenges of convergence between the online and the physical environment should be addressed in all reviews of public policy, including tax matters. To cope with these discriminations, two possible options exist: either to maintain the standard VAT rate, or to transpose into the digital environment the reduced rates existing for goods in traditional supports.

Q19. Do you think that the current rates structure creates major obstacles for the smooth functioning of the single market (distortion of competition), unequal treatment of comparable products, notably online services by comparison with products or services providing similar content or leads to major compliance costs for businesses? If yes, in what situations?

Q20. Would you prefer to have no reduced rates (or a very short list), which might enable Member States to apply a lower standard VAT rate? Or would you support a compulsory and uniformly applied reduced VAT rates list in the EU notably in order to address specific policy objectives as laid out in particular in 'Europe 2020'?

5.3. Reducing 'red tape'

5.3.1. *The Commission Action Programme for Reducing Administrative Burdens and streamlining VAT obligations*

Following from the European Council's endorsement in 2007²² of the Commission Action Programme²³ to reduce the administrative burdens arising from EU

²⁰ The summary report of the outcome of the public consultation 'Review of existing legislation on VAT reduced rates' carried out in 2008 is available at http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/summary_report_consultation_vat_rates_en.pdf.

²¹ Commission's Communication, *A Digital Agenda for Europe*, COM(2010) 245, 19.5.2010, p. 9.

²² Presidency conclusions of the European Council (7/8 March 2007), p. 10.

²³ COM(2007) 23, 21.1.2007.

legislation by 25% by 2012, the Commission presented a plan²⁴ for VAT, among other areas, in 2009.

This plan contains 16 measures such as abolishing the annual summarizing VAT return or intra-EU acquisition listings and reducing the frequency of VAT returns and is supported by the High Level Group of Independent Stakeholders on Administrative Burdens chaired by Edmund Stoiber²⁵. Six of the measures have either been adopted or proposed by the Commission.

As a consequence of the new rules on the place of supply of services, in a recent opinion the High Level Group recommended additional burden reduction measures.

The VAT Directive includes a common set of obligations and Member States have some freedom in deciding how to meet them. This leads to a patchwork of national VAT obligations and, in particular, VAT returns which require different types and volume of information. Devising a standard EU VAT return available in all languages, which businesses could opt to use but which all Member States would have to accept, could be a way forward to reduce compliance costs.

Moreover, Member States may impose other obligations which they deem necessary to ensure the correct collection of VAT and to prevent evasion, without any EU requirement to assess their impact beforehand. The scope and costs of these additional obligations can be found in the study done for DG Enterprise as part of the Better Regulation programme²⁶.

A more uniform approach in this area would certainly facilitate the development of IT tools for compliance with VAT obligations EU-wide and reduce administrative burdens for businesses operating in a number of Member States. However, changing current practice in the Member States would have a cost both for tax administrations and for businesses, including those that only have to comply with such obligations in a single Member State.

If full harmonisation is not appropriate, differences could be limited by defining at EU level a maximum set of standardised VAT obligations that may be imposed by the Member States. IT systems could more easily handle a pre-defined range.

Q21. What are the main problems you have experienced with the current rules on VAT obligations?

Q22. What should be done at EU level to overcome these problems?

Q23. What are your views particularly on the feasibility and relevance of the suggested measures including those set out in the reduction plan for VAT (N° 6 to 15) and in the opinion of the High Level Group?

²⁴ COM(2009) 544, 22.10.2009 and Annex.

²⁵ Opinion adopted 28.5.2009 http://ec.europa.eu/enterprise/policies/better-regulation/administrative-burdens/high-level-group/index_en.htm.

²⁶ http://ec.europa.eu/enterprise/policies/better-regulation/files/abst09_taxlaw_implicit.zip.

5.3.2. *Small businesses*

With the ‘Small Business Act for Europe’²⁷, the EU adopted two key principles to address the needs of SMEs: design rules according to ‘Think Small First’ and help SMEs to benefit more from the opportunities offered by the single market. Improving the business environment for SMEs is also part of one of the Commission’s flagship initiatives of ‘Europe 2020’, ‘An industrial policy for the globalisation era’.

The special scheme for small enterprises aims primarily to reduce the administrative burden of applying the normal VAT rules: businesses with an annual turnover below a certain threshold are entitled to exemption from VAT.

However, this scheme has a number of shortcomings. The legal framework, based largely on when Member States joined the EU, has created differences in the thresholds and in the leeway given to Member States to set thresholds. In addition, the calculation method of the threshold and scope of the scheme do not take the single market into account: for example, the scheme does not cover supplies made in other Member States. Moreover, registration for VAT, a VAT declaration and VAT payments are required for certain cross-border purchases, particularly services.

The Member States can apply other simplified schemes for charging and collecting VAT, such as a flat rate scheme, but these are applied in different ways and are limited to domestic activity.

All these schemes are a fragmented response to the fact that VAT compliance costs for small businesses are relatively higher than for big companies, particularly when they conduct business across the EU.

An EU-wide scheme with a common threshold and greater scope for reducing compliance costs across the single market and thus encouraging small business growth would seem the obvious solution.

Besides schemes for small businesses, a special scheme for farmers who have difficulty applying the normal rules was introduced in the 1970s. The rationale for maintaining this scheme is to be considered since approaches to help small businesses could meet small farmers’ needs for simplification too.

Q24. Should the current exemption scheme for small businesses be reviewed and what should be the main elements of that reassessment?

Q25. Should additional simplifications be considered and what should be their main elements?

Q26. Do you think that small business schemes sufficiently cover the needs of small farmers?

²⁷ COM(2008) 394, 25.6.2008.

5.3.3. Other potential simplification initiatives

5.3.3.1. A one-stop-shop mechanism

For B2C transactions subject to VAT in a Member State other than that in which the supplier is established, complying with the particular rules of that Member State is not always easy. There is evidence that businesses avoid such transactions because of the difficulties. In other cases, the rules are ignored and VAT is charged in the Member State where the supplier is established rather than where the supply actually takes place.

The one-stop-shop scheme proposed by the Commission in 2004²⁸ and still on the table of the Council was intended to cater for such cases. The underlying concept remains valid. A narrower scheme exists for B2C electronic services supplied by non-EU suppliers and will be extended in 2015 to telecommunication and broadcasting services and to EU suppliers.

As long as VAT is based on taxation at destination, the one-stop-shop is desirable as a simplification measure and would increase compliance and cross-border trade. VAT regulations were among the key barriers identified in the Commission's Communication on 'Cross-Border Business to Consumer e-Commerce in the EU'²⁹. It is probably even more relevant today, since over 60% of people in the EU use regularly the internet and 60% of these buy goods or services online. This figure has doubled since 2004 (when the proposal was first presented) and can only grow with the emphasis placed on the 'Digital Agenda'³⁰.

Q27. Do you see the one stop shop concept as a relevant simplification measure? If so, what features should it have?

5.3.3.2. Adapting the VAT system to large and pan-European businesses

The legal structure (holding/subsidiaries or headquarter/branches) of businesses conducting economic activities in different Member States has a major influence on the VAT treatment of those activities. For example, it affects the rules on cross-border transactions between the different parts of the business and the calculation of deductible input VAT.

Businesses complain about the lack of consistent and clear VAT rules suited to existing corporate structures. Tax authorities, on the other hand, are concerned about the opportunities for VAT avoidance schemes in complex corporate structures.

Considering transactions between interrelated companies or supplies of goods between branches to be outside the scope of VAT, or extending the territorial scope of VAT groupings, could reduce VAT compliance costs on a large number of transactions within the EU. On the other hand, it would have to be ensured that such a move would not create unfair advantages for big businesses compared to smaller ones, or new means of fraud or tax avoidance.

²⁸ COM(2004) 728, 29.10.2004.

²⁹ COM(2009) 557, 22.10.2009.

³⁰ Op. cit.

Q28. Do you think that the current VAT rules create difficulties for intra-company or intra-group cross-border transactions? How can these difficulties be solved?

5.3.3.3. Synergies with other legislations

Efforts made to make customs procedures on importation easier must take account of VAT to maximise the benefits. Consistency between VAT law and other tax legislation, notably excise duties, could also simplify compliance for businesses.

Consultation on simplifying VAT collection procedures in connection with centralised customs clearance was launched recently but there might be other areas which could be looked at.

Q29. In which areas of VAT legislation do synergies with other tax or customs legislation need to be promoted?

5.4. A more robust VAT system

5.4.1. *Reviewing the way VAT is collected*

The way VAT is collected has hardly changed since the tax was first introduced in the EU; it still depends primarily on self-assessment by the taxpayer followed later by audits by the tax administration.

As part of the ongoing debate on the strategy to combat VAT fraud, which questioned the efficiency of this collection method, in 2009 the Commission launched a feasibility study on ways of improving and simplifying the collection of VAT by means of modern technologies and/or via financial intermediaries.

The following four models were explored in some depth:

- The customer instructs his bank to pay for the goods or services, with the bank splitting the payment into the taxable amount paid to the supplier and the VAT amount transferred directly to the tax authority. This model eliminates ‘missing trader’ fraud but it would require substantial changes in the way all businesses and tax administrations handle VAT. The issue of how to deal with cash or credit card transactions needs further work.
- All invoice data is sent in real time to a central VAT monitoring database. The tax authorities would obtain information much more quickly than they do now and a number of current VAT obligations could be abolished. It would be more effective and less burdensome if e-invoicing were used for all B2B transactions.
- The taxable person uploads predefined transaction data presented in an agreed format into a secure VAT data warehouse maintained by the taxable person and accessible, either directly or on demand at very short notice, to the tax authority. Some Member States have moved in that direction and it has not caused major problems. However, the model does not prevent ‘missing trader’ fraud; if the trader goes missing, his or her VAT data warehouse disappears too. But it does allow quicker detection.

- A taxable person's VAT compliance process and internal controls are certified. Some Member States have moved in that direction. The model should increase trust between tax authorities and taxpayers; however, the certification process is time-consuming and requires substantial investment by tax authorities in human resources.

The study³¹ shows all four models to have a positive cost-benefit ratio. The required initial investment cost differs, however, and this influences how soon the national treasuries receive a net benefit. Moreover, a combination of the different models could also be a more efficient way forward.

Q30. Which of these models looks most promising in your view and why, or would you suggest other alternatives?

5.4.2. *Protecting bona fide traders against potential involvement in VAT fraud*

Several Member States have introduced national measures to limit VAT losses from 'missing trader' fraud by trying to recover the tax from other taxable persons involved in the same transaction chain. The European Court of Justice has confirmed that where the tax administration is able to prove that the customer knew or should have known that his or her purchase was part of a transaction connected with fraudulent evasion of VAT, it can refuse the customer the right to deduct.

Tax administrations must prove such knowledge in each individual case. This is a lengthy, costly and complicated procedure. In addition, it risks leaving taxable persons in a vulnerable position, particularly when dealing with a new supplier. They have to perform additional checks on the compliance of each supplier. Bona fide businesses nonetheless run a risk that their right to deduct will be challenged because they have inadvertently been dealing with fraudsters.

The first model set out under point 5.4.1 removes opportunities for 'missing trader' fraud by means of a far-reaching, compulsory mechanism of split payment. A simpler, optional mechanism could also be envisaged.

The optional mechanism would allow customers to protect themselves against such risks and save them from checking their suppliers' compliance. The customer would exercise the option by paying the VAT directly to the tax authorities and the net amount to his supplier.

For tax authorities, this would ensure the collection of VAT on transactions judged by traders themselves to be a potential risk. They would also obtain additional information and be alerted to new trends in fraud.

However, this option may have an unwelcome impact on the relation between the supplier and customer and therefore on business activities in general. This option could also have a cash flow effect for suppliers.

Q31. What are your views on the feasibility and relevance of an optional split payment?

³¹ http://ec.europa.eu/taxation_customs/index_en.htm.

5.5. An efficient and modern administrating of the VAT system

Given taxpayers' crucial role in making the VAT system work, the efficiency of their relationship with the tax authorities will greatly influence the cost of administering the system, for both parties. This relationship is determined not only by reporting, payment or auditing obligations but also by the quality, reliability and accessibility of information provided by tax authorities.

Tax administration issues are primarily the Member State's responsibility. However, these issues have an impact on the proper functioning of the single market, as confirmed by the Court of Auditors' report³² on the EU's 'own resources'.

The Commission pointed to the need to reflect on these issues in its Communication of December 2008, *A coordinated strategy to improve the fight against VAT fraud in the EU*³³. It suggested devising a new approach based on voluntary compliance, risk assessment and monitoring, with the aim of reducing both the involvement of tax authorities and the administrative burden on businesses. The following measures which could be envisaged are not exhaustive:

- enhancing the dialogue between tax authorities and other stakeholders, for instance by setting up a permanent discussion forum allowing tax authorities and business representatives at EU level to exchange views;
- pooling best practice in the Member States, for instance by drafting guidelines for streamlining administrative practices and abolishing unnecessary burdens on businesses;
- drafting an EU policy on voluntary compliance tailored to the EU VAT system through specific arrangements with stakeholders; for instance, by developing the idea of 'Partnerships' between tax administrations and taxpayers and of prior rulings on the tax treatment of certain transactions;
- paying attention to IT issues when implementing the new VAT rules: defining a proper timeframe and agreeing on a work process for adapting IT systems, both for businesses and tax authorities; facilitating automated information transfer between taxpayers and the tax authorities through better interoperability; and perhaps developing specific software to be supported at EU level and made available to all Member States.

Q32. Would you support these suggestions to improve the relationship between traders and tax authorities? Do you have other suggestions?

³² In their audit work for the Annual Report for 2008, the European Court of Auditors took the view that data collection for the reports should become one of the means of ensuring uniform application of the VAT Directive across all Member States and equal treatment of all taxpayers. See Article 12 of Council Regulation (EC) No 1553/89.

³³ COM(2008) 807, 1.12.2008.

5.6. Other issues

This paper sets out a range of topics for discussion but they are not exhaustive. The objective is to launch as broad a debate as possible, so it is an opportunity to bring other issues on board.

Q33. Which issues, other than those already mentioned, should be addressed in considering the future of the EU VAT system? What solution would you recommend?

6. HAVE YOUR SAY

The purpose of this Green Paper is to trigger and encourage public debate on the future of the EU VAT system. The Commission therefore invites all interested parties to submit their contributions in response to the questions raised in this Green Paper by 31 May 2011, preferably by e-mail and in Word format to 'TAXUD-VAT-greenpaper@ec.europa.eu'.

The contributions do not necessarily need to cover all of the questions raised in this paper. They can be limited to those questions of interest to you. Please state clearly which topics your contributions relate to and specifically the number of the question you are answering.

If you contribute on all the issues raised in this Green Paper, we would be interested in knowing how you would rank the different items according to importance.

Contributions will be published on the internet. It is important to read the specific privacy statement on how your personal data and contribution will be dealt with on the following website http://ec.europa.eu/taxation_customs/index_en.htm.

A report summing up the conclusions drawn from the contributions will also be published on that website.

Based on the conclusions that can be drawn from this debate, and as announced in the Commission Work Programme for 2011³⁴, the Commission will present by the end of 2011 a Communication identifying those priority areas in which further action at EU level would be appropriate. Subsequent initiatives following that Communication would be based on thorough impact assessments.

³⁴ COM(2010) 623, 27.10.2010, *Commission Work Programme 2011*.