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The Definitive VAT System: Breaking with Transition

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The year this Review was launched, 1991, was a crucial year for EU VAT. Two decades after the introduction of the common VAT system, some of the limitations of the European VAT system had become more evident, and in the summer of 1987, following the release of its 1985 White Paper on Completing the Internal Market, [1] the European Commission issued what became known as the 1987 proposals.[2] The proposals were a resounding failure, regarded from the outset as widely ambitious in both their aims and their proposed methods for achieving these aims.[3] By late 1989 it was clear that the Council would fail to reach the necessary political consensus for their approval. The political focus shifted then towards agreeing upon a compromise VAT system which permitted the abolition of border controls at the end of 1992. During the period between 1989 and 1991, a series of key meetings of the ECOFIN Council of Ministers took place, from which emerged the basic shape of the VAT arrangements which were to become known as the "transitional VAT system".

The VAT transitional system, as agreed in 1991, was supposed to be in place for a period of four years following the elimination of fiscal frontiers on January 1, 1993. Instead the temporary system became the definitive system. In 1996 the European Commission released a work programme that contained an outline of the envisaged European VAT system, as well as a detailed time plan extending through to mid-1999.[4] The work programme diverged from the 1987 proposals primarily on its approach: the 1987 proposals had been based on an immediate switchover to the definitive system, what the Commission has referred to as a "big bang" approach; whilst the 1996 programme envisaged a gradual changeover to the definitive system. Unfortunately, as acknowledged by the Commission a few years later, this gradual approach proved as difficult to implement as the 1987 "big bang".[5] In 2004 the European Commission tried a different approach: a system which would allow similar results to those sought by the 1987 proposals, but with a stronger emphasis on compliance – and crucially, using a different terminology. Under the 2004 proposal, a One-Stop-Shop would apply to all business-to-consumer (B2C) supplies, allowing a business to register only once, in one Member State, and using a single VAT number for all B2C supplies

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[1] *Completing the Internal Market – White Paper from the Commission to the European Council*, COM(85) 310, June 14, 1985.

[2] See *Proposal for a Council Directive completing the common system of value added tax and amending Directive 77/388/EEC – Approximation of VAT rates*, COM(87) 321 final, August 21, 1987; *Proposal for a Council Directive completing and amending Directive 77/388/EEC – Removal of fiscal frontiers*, COM(87) 322 final, August 21, 1987; *Completing the internal market – the introduction of a VAT clearing mechanism for intra-Community sales*, Working document from the Commission, COM(87) 323, August 5, 1987; and *Proposal for a Council directive instituting a process of convergence of rates of value added tax and excise duties*, COM(87) 324 final, August 21, 1987.

[3] A.J. Easson, "The Elimination of Fiscal Frontiers", in R. Bieber *et al*. (eds.), *1992: One European Market? A Critical Analysis of the Commission's Internal Market Strategy* (Baden-Baden: Nomos Verlagsgesellschaft, 1988), 241-260, at 260.

[4] See *A common system of VAT – A programme for the Single Market*, COM(96) 328 final, July 22, 1996.

[5] *A strategy to improve the operation of the VAT system within the context of the Internal Market*, Communication from the Commission to the Council and the European Parliament, COM(2000) 348 final, June 7, 2000, at 4.

made within the scope of the scheme.[6] The proposal received very favourable feedback from traders and other interested parties, and was targeted as a high priority by the various Presidencies of the Council of the European Union until mid-2006.[7] Ultimately, however, it had a similar fate to previous proposals, proving impossible to secure the necessary unanimous agreement of all Member States, primarily as a result of a lack of mutual trust between them. Almost two decades after the introduction of the transactional system, the European Commission finally announced in its 2011 Green Paper the formal abandonment of the 1987 objectives of implementing a definite VAT system, implicitly endorsing the transitional system.[8]

Of course much progress had been achieved since 1991, not least in the progressive adaptation of the EU VAT system to the digital economy, with the approval of new place of supply rules in 2008 and the consequent introduction of the VAT MOSS in 2015;[9] yet, there was a sense that any progress achieved was patchy, and that meaningful change had not, and could not be achieved in the context of the existing procedure for approval of new EU VAT legislation. This sense that there was a lack of meaningful progress has only accelerated over the last decade: as our economies changed almost beyond recognition, there was an increasing awareness that the EU VAT system was simply not equipped to deal with the globalisation and the rapid digitalisation of the economy. Clearly emboldened by these developments, and 6 years since the formal abandonment of the aim to implement a definitive VAT system, the Commission is now throwing its hat back into the ring. As part of a wider strategy to reform the VAT system set out in 2015, it has announced a series of measures whose ultimate objective is "to replace the current transitional arrangements for the taxation of trade between Member States by definitive arrangements",[10] which, despite the re-packaging, are eerily reminiscent of its previous proposals.

The Proposed Definitive VAT System

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[6] *Proposal for a Council Directive laying down detailed rules for the refund of value added tax, provided for in Directive 77/388/EEC, to taxable persons not established in the territory of the country but established in another Member State*, COM(2004) 728 final, 29 October 2004.

[7] See detailed discussion in R. de la Feria, "Sections 103-106: VAT – Mini-One-Stop-Shop (MOSS)" (2014) *British Tax Review* 4, 438-443.

[8] *Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the future of VAT – Towards a simpler, more robust and efficient VAT system tailored to the single market*, COM(2011) 851 final, December 6, 2011. On the Green Paper see R. de la Feria, "The 2011 Communication on the Future of VAT: Harnessing the economic crisis for EU VAT reform" (2012) *British Tax Review* 2, 119-133; A. van Doesum and GJ van Norden "EU 2011, EUtopia and EU 2020: the European Commission's Green Paper on the Future of VAT" (2011) *British Tax Review* 253; and H. Kogels, "The European Commission's Green Paper on VAT" (2011) *International VAT Monitor* 3, 141-143.

[9] For a commentary on the importance of these changes see: R. de la Feria, n. 7 above. See also: Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services, [2008] OJ L44/11; Council Directive 2008/9/EC of 12 February 2008 laying down detailed rules for the refund of value added tax, provided for in Directive 2006/112/EC, to taxable persons not established in the Member State of refund but established in another Member State [2008] OJ L44/23; and Council Regulation (EC) No 143/2008 of 12 February 2008 amending Regulation (EC) No 1798/2003 as regards the introduction of administrative cooperation and the exchange of information concerning the rules relating to the place of supply of services, the special schemes and the refund procedure for value added tax [2008] OJ L44/1.

[10] European Commission, *Follow-up to the Action Plan on VAT: Towards a single EU VAT area - Time to act*, COM(2017) 566 final, 4 October 2017,at 6.

In April 2016 the European Commission presented an Action Plan for the creation of a single EU VAT area.[11] The Action Plan acknowledged that whilst a depth reform of the EU VAT system was required, in the past the unanimity requirement to approve new legislation had proved to be a "serious" challenge to meaningful reform. It contended, however, that "business as usual was no longer an option": the compliance costs for business are too big, the risks of fraud too great, and the inefficiency too grave. It therefore proposed a series of measures directed primarily at the reform of cross-border EU trade, the introduction of strong anti-fraud measures, the treatment of SMEs, and the reform of the VAT base (i.e. reduced rates). Of course, the limitations of the EU VAT system identified by the Commission in the Action Plan were not new, but it is undoubtedly true that the globalisation and the digitalisation of the economy had added prominence to these limitations – and similarly to past initiatives, the Commission signalled that it was keen on harnessing this prominence for real reform.[12]

The first set of legislative proposals were presented in December 2016. The proposals, which were part of the Digital Single Market Strategy,[13] were reportedly aimed at adapting the VAT cross-border rules on business-to-consumers (B2C) transactions to the digital economy, but it was clear that they constituted the stepping stone for the wider reforms to be proposed this year. The measures set out in the proposals concerned particular: (*i*) amendments to the existing Mini-One-Stop-Shop (MOSS), to include the introduction of an intra-EU cross-border VAT threshold and new simplified compliance requirements; (*ii*) extension of the existing MOSS to intra-EU supplies of services, other than those to which it currently applied, and to distance sales of goods, both intra-EU and from third-countries; (*iii*) the removal of current intra-EU distance sales thresholds, as well as VAT exemption for imports of small consignments from outside the EU, the so-called Low Value Consignment Relief (LVCR); and (*iv*) amendments to existing rules to enable Member States to apply a reduced VAT rate to e-publications, such as e-books and online newspapers. Rather surprisingly for those used to prolonged Council discussions often followed by disappointment, all these proposals, excluding that one concerning the application of reduced rates to e-publications, were approved in December 2017, barely a year since their presentation.[14]

Whilst the details of the new measures have been subject to some criticism,[15] overall the package constitutes significant progress, addressing many of the concerns of SMEs as regards the operation of the MOSS, as well as

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[11] *Action plan on VAT: Towards a single EU VAT area - Time to decide*, Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee, COM(2016) 148 final, 7 April 2016. For details on the plan see also C. Herbain, "Towards a Single EU VAT Area" (2016) *British Tax Review* 4, 402-407

[12] R. de la Feria, n. 8 above.

[13] European Commission, *A Digital Single Market Strategy for Europe*, Communication from the Commission to the European Parliament, the Council, the EESC and the Committee of Regions, COM(2015) 192 final, 6 May 2015.

[14] Council Directive (EU) 2017/2455 of 5 December 2017 amending Directive 2006/112/EC and Directive 2009/132/EC as regards certain value added tax obligations for supplies of services and distance sales of goods, *OJ L 348, 29.12.2017, p. 7-22*; Council Implementing Regulation (EU) 2017/2459 of 5 December 2017 amending Implementing Regulation (EU) No 282/2011 laying down implementing measures for Directive 2006/112/EC on the common system of value added tax, *OJ L 348, 29.12.2017, p. 32–33*; and Council Regulation (EU) 2017/2454 of 5 December 2017 amending Regulation (EU) No 904/2010 on administrative cooperation and combating fraud in the field of value added tax, *OJ L 348, 29.12.2017, p. 1-6*.

[15] See I. Lejeune and C. Herbain, "Recent developments on EU VAT: VAT Digital Single Market Package" (2018) *British Tax Review* 1 (forthcoming).

closing loopholes that had allowed fraud to spread in the context of the digital economy.[16] Building on the new momentum around the digital package, the Commission quickly moved on to setting out the measures necessary for implementing the single EU VAT area, presenting an updated action plan in late 2017.[17] The plan envisages the transition from a MOSS to a One-Stop-Shop (OSS), coupled with a significant strengthening of anti-fraud policy. Although the proposed move from a MOSS to an OSS was foreseeable,[18] the new momentum created around the digital economy had (probably) precipitated it.

The plan proposes a gradual, two-step, approach. In the first stage, new rules would be approved, which would pave the way for the abolition of the transitional VAT system and the introduction of an OSS, but intra-EU B2B supplies of goods would still be subject to the reverse-charge mechanism. In a second stage, the OSS would apply to all cross-border supplies of goods and services: the supplier would charge VAT to its customers at the rate of the Member State of destination, but VAT would be declared and paid in the Member State where the supplier is established via the OSS mechanism; the supplier and not the customer, would therefore be liable for VAT on all intra-EU supplies of goods and services, as opposed to what happens now where the liability for VAT depends on the nature of the supply and the identity of the customer (B2C or B2B). Although the system is broadly similar to that currently applied under the MOSS, the wider scope of application presents new challenges particularly insofar as safeguards are concerned, so that the proposed introduction of the OSS would be accompanied by significant changes in compliance obligations. In conjunction with the introduction of the OSS, new anti-fraud measures would be implemented in the second stage, to include measures strengthening Member States' capacity to conduct joint risk analysis within the framework with Eurofisc, and facilitating the sharing of VAT intelligence with law enforcement bodies at EU level, such as Europol, OLAF, and the new European Public Prosecutor Office (EPPO).[19] The aim of these measures is to both address the limitations of the current system and curtail the current (significant) levels of fraud,[20] as well as to pre-empt new fraud opportunities potentially arising from the introduction of the OSS.

The first stage proposals were presented concurrently with the updated action plan, as set out in Table 1. Reflecting the main aims of the initiative, the proposals for a definitive VAT system, can be broadly divided into three types, namely: (*i*) new substantive rules to introduce taxation at destination, and the OSS; (*ii*) new compliance rules, adapted to the new system; and (*iii*) new administrative cooperation rules to combat fraud. In addition to these proposals, however, another one is added, namely a proposal on the so-called modernisation of current VAT rates rules. The Commission argues that with "goods and services taxed in the Member State of destination, suppliers

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[16] EESC, *Digital Single Market VAT (e)-package (VAT on e-commerce, e-publications, e-books)*, ECO/421, 06/07/2017, *OJ C 345, 13/10/2017, p 79*.
[17] European Commission, n. 10 above.
[18] Indeed see R. de la Feria, n. 7 above.
[19] VAT fraud is within the remit of the newly created EPPO. See Council Regulation (EU) 2017/1939 of 12 October 2017 implementing enhanced cooperation on the establishment of the European Public Prosecutor's Office ('the EPPO'), *OJ L 283, 31.10.2017, p. 1-71*. See also European Parliament, *Towards a European Public Prosecutor's Office (EPPO)*, PE 571.399, 2016, in particular at 23-25.
[20] Although levels of fraud are by nature difficult to determine, the Commission estimates that €50 billion are lost every year to cross-border fraud, see European Commission, n. 10 above.

derive no significant benefit from being established in a lower-rate Member State", and it therefore concludes that "diversity in VAT rates would therefore no longer disrupt the functioning of the single market".[21] The proposal includes two main elements, namely: (*i*) removal of all temporary derogations to the existing VAT rules, many of which were introduced as part of the transitional VAT system; and, (*ii*) introduction of new rules which allow Member States to apply up to five reduced rates to any products, except to those expressly listed. The proposal therefore deems the e-publications rate proposal redundant; the only element of the digital VAT package that was still pending.

Table 1: Current EU VAT Initiative

Legislative Proposal	Status
I. Digital Package	
Proposal for a Council Directive amending Directive 2006/112/EC and Directive 2009/132/EC as regards certain value added tax obligations for supplies of services and distance sales of goods, COM(2016) 757 final, 1 December 2016	Approved
Proposal for a Council Implementing Regulation amending Implementing Regulation (EU) No 282/2011 laying down implementing measures for Directive 2006/112/EC on the common system of value added tax, COM(2016) 756, 1 December 2016	Approved
Proposal for a Council Regulation amending Regulation (EU) No 904/2010 on administrative cooperation and combating fraud in the field of value added tax, COM(2016) 755, 1 December 2016	Approved
Proposal for a Council Directive amending Directive 2006/112/EC, as regards rates of value added tax applied to books, newspapers and periodicals, COM(2016) 758, 1 December 2016	Pending
II. Definitive VAT Regime	
Proposal for a Council Directive amending Directive 2006/112/EC as regards harmonising and simplifying certain rules in the value added tax system and introducing the definitive system for the taxation of trade between Member States, COM(2017) 569 final, 4 October 2017	Pending
Proposal for a Council Implementing Regulation amending Implementing Regulation (EU) No 282/2011 as regards certain exemptions for intra-Community transactions, COM(2017) 568 final, 4 October 2017	Pending
Proposal for a Council Regulation amending Regulation (EU) No 904/2010 as regards the certified taxable person, COM(2017) 567 final, 4 October 2017	Pending
Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax, COM(2018) 20 final, 18 January 2018	Pending

[21] European Commission, n. 10 above.

The proposals currently pending are meant to introduce "the cornerstones of the definitive system for intra-Union B2B trade".[22] In the second step towards the implementation of the definitive VAT system, the Commission will present detailed technical provisions for the implementation of those cornerstones. The presentation of these legislative proposals is envisaged for mid-2018.

Radical VAT Reform?

Over 25 years since its approval, we are finally 'breaking with transition'.[23] Many reforms have been considered, or even proposed, in the intervening years since the approval of the transitional VAT system, but significant progress had so far eluded the Commission: broad scope reforms did not achieve the necessary consensus; and consensual legislative amendments were narrow in scope. Now, for the first time in 25 years – and arguably since the inception of the EU VAT system – an overarching reform is underway: whilst it is too early to say whether the proposals for a definitive VAT regime will receive the Council's unanimous approval, there is a clear sense of momentum, further confirmed by the rapid approval of the VAT digital package. Like with previous initiatives regarding the EU VAT system, success is largely dependent on the Commission's ability—or inability—to harness critical economic and political moments in EU history for real reform. At present it seems that the digitalisation of the economy may succeed where others have failed, by delivering a broad reform of the rules applicable to cross-border trade.

The proposals for a definitive VAT system, together with the newly approved digital package, represent therefore real progress to the system implemented in 1992. Yet, they are not enough. On their own they will not deliver the fair, efficient and fraud-proof system that the Commission is expressly aiming for; achieving those aims requires in addition to those proposals, a new approach to tax enforcement,[24] as well as, crucially, a reform of the rules currently governing the VAT base.

Insofar as the VAT base is concerned, the ongoing reform does include a proposal for amendment of the current rules. As they stand, however, this proposal will not contribute to a fair, efficient or fraud-proof EU VAT system, but rather risks creating one that is less fair, less efficient, and more prone to fraud than the current one. The proposals have the merit of rationalising the current rates rules, removing temporary derogations which had become *de facto* permanent,[25] and improving legal transparency, but they are based on the wrong assumption, namely that full destination-based taxation removes the need for harmonisation of the base. It is true that taxation at destination is likely to remove the incentives to re-location; but wrong to infer that these incentives are the only reason for

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[22] European Commission, *Proposal for a Council Directive amending Directive 2006/112/EC as regards harmonising and simplifying certain rules in the value added tax system and introducing the definitive system for the taxation of trade between Member States*, COM(2017) 569 final, 4 October 2017.

[23] The expression is borrowed from my PhD dissertation, entitled "Breaking with Transition – The EU VAT System and the Internal Market", and submitted at the University of Dublin, Trinity College in 2006, which contented that the EU VAT system was contrary to the concept of Internal Market, and advocated the abolition of the transitional system. The dissertation was later published as R. de la Feria, *The EU VAT System and the Internal Market* (IBFD, 2009).

[24] See R. de la Feria, "Tax Fraud and the Rule of Law" (2018) *Oxford University Centre for Business Taxation* WP 18/02.

[25] As discussed in R. de la Feria, "Blueprint for Reform of VAT Rates in Europe" (2015) *Intertax* 43(2), 155.

harmonising VAT rates, and thus that their removal somehow legitimises disharmonisation. As the Commission implicitly acknowledges, the proposed disharmonisation is expected to increase the levels of both rates discrepancy – across Member States –, and rates differentiation – across products – but as opposed to what it argues, these increases can have far reaching effects on the functioning of the Internal Market.

A detailed assessment of the merits and demerits of applying reduced rates are outside the scope of this Editorial,[26] but the potential consequences of increased discrepancy and differentiation for the Internal Market are cause for serious concern. Discrepancies and differentiation are likely to increase market distortions nationally and across the Internal Market, as competing products are treated differently, creating an unequal playing field; compliance costs are also likely to increase, which will impact particularly negatively on SMEs, potentially deterring intra-EU trade; similarly with administrative costs, pushed up by the need to enforce and litigate complex rate structures; further erosion of the base is probable, given political economy dynamics, favouring the most vocal lobbyists, and negatively impacting on national (and EU own resources) revenue; and the opportunities for evasion (and avoidance) will increase, as they are often directly correlated to exclusions from the base. An unequal playing field for businesses and increased compliance costs will decrease fairness; increased administrative costs and further erosion of the base will decrease efficiency; and new opportunities for fraud will make the system more prone to fraud, not less. It is therefore difficult to see how this proposal can in any way improve the functioning of the Internal Market or remove distortions to competition, as required by Article 113 TFEU. To use that Article as a legal basis for the proposal seems, therefore, to be in strict contravention of the EU principle of conferral of powers.[27] In the Impact Assessment, which accompanies the proposal, the Commission acknowledges these concerns, but alas, fails to address them.[28]

The current EU VAT base undermines the functioning of the Internal Market, but disharmonisation and further erosion of that base is not the answer; a fairer, more efficient, fraud-proof, VAT base, is. The ongoing reform has the potential to deliver a significantly improved EU VAT, equipped to meet many of the challenges of a global, digitalised economy, but we must rise to the challenge of building a fairer and more efficient base. To do less "would be to betray the trust invested in us; and it would be to offer the peoples of Europe … a less prosperous future than they could otherwise enjoy".[29]

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[26] A detailed cost-benefit analysis is presented in R. de la Feria, n. 25 above.

[27] This argument is comprehensively developed in R. de la Feria and M. Schofield, "Towards an [Unlawful] Modernized EU VAT Rate Policy" (2017) *EC Tax Review* 2, 89-95.

[28] *Impact Assessment Accompanying the document Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax*, Commission Staff Working Document, SWD(2018) 7 final, 18 January 2018, at 15.

[29] European Commission, n. 1 above.