Value added tax VAT: exemption on the final importation of certain goods

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1. Category of referral: Proposal for a Council Directive 2. Expected date of referral: November /December 1994 3. Committee responsible: ECON 4. Previous Community legislation: Directive 77/388 /EEC (the Sixth VAT Directive), as amended in particular by Directives 91/680/EEC, 92/77/EEC and 92 /111/EEC. These have established a "transitional" VAT system, applying until the end of 1996. Article 35a of the amended Directive requires the Commission to "submit proposals for a definitive system" before the end of 1994 and for the Council to reach a decision on it before the end of 1995. Co-operation between the tax administrations of Member States was strengthened by Regulation 92/218/EEC. 5. Previous position of EP: Resolutions of the European Parliament have repeatedly stressed that the Single Market will not be complete until the charging of VAT on intra-Community "supplies", and its remission on intra-Community "acquisitions", is ended. In its Resolution of 15.7.1991 on the approximation of indirect taxation, Parliament accepted transitional arrangements "on the understanding that both Commission and Council are committed to the full abolition of fiscal frontiers at the earliest possible date". 6. Situation in the Member States: The transitional VAT system, subject to certain derogations, has been in effect in all Member States since 1st. January 1993. The Commission is under an obligation to report on the workings of this system before the end of 1994. 7. Content of the planned legislation: A key element in the proposal will be to change the system under which VAT is levied on goods traded between Member States. Under the transitional system the "destination principle" applies: i.e. goods being sent to another country have been zero-rated, and VAT has then been charged in, and at the rate of, the country of consumption. The definitive system should apply the "origin principle": i.e. when goods are sent to another country, the normal rate of VAT will be charged, and may be deducted as input tax by traders in the country of consumption. "Origin", of course, already applies to final consumers. In theory, goods moving between the UK and France, or between France and Germany, would then be treated in exactly the same way as goods moving between England and Scotland, or between Bavaria and Baden-Wurtembourg. However, this will not be the case in one important respect: VAT revenues will continue to be paid into different national budgets. If traders in one Member State have the right to deduct from their VAT bill the input taxes paid in other Member States, substantial shifts in revenue are likely. Specifically, countries with a net intra-Community trading surplus will gain revenue, the others will lose. Were VAT a true "value added tax", this would not matter: revenue would correctly accrue to the country where the value was added. VAT is currently regarded, however, as a general consumption tax. The proposal should therefore outline a mechanism for "clearing" revenue from the gainer countries back to the rest. This could be done either on the basis of detailed VAT returns (the "micro" solution) or on the basis of trade-flows, consumption statistics, etc. ("macro" solutions).Alternatively, all VAT could be paid into the single, Community budget, and redistributed via expenditure programmes. The proposal should also address a number of other important issues: i) To what extent should the rates of VAT be further harmonised? At present only a minimum standard rate of 15% has been agreed until the end of 1996. Member States also have an option to choose "one or two reduced rates", which must be not less than 5%., to transactions listed in Annex H of the 6th.VAT Directive. Certain derogations also apply, notably the right of the UK and Ireland to apply a zero rate. Apart from issues of competition, a uniform rate (or rates) of VAT throughout the Union would make both a clearing system and the right of traders to deduct input tax levied in another Member State very much simpler. ii) Since liability to VAT arises at the "place of supply", where should this be? Article 8 of the 6th. Directive defines it as the place where goods are when they change hands. But this can give rise to complications, with firms having to register for VAT in several different Member States. The alternative would be the "place of business" of the supplier, irrespective of where goods actually were or where a service was carried out. iii) The transitional VAT system contains three "special regimes" covering purchases from another Member State: new means of transport; distance sales; and purchases by exempt bodies. When a final consumer buys anything, the rate

of VAT charged is normally that of the country where the sale is made. However, a new car or an item bought from a mail-order catalogue (subject to certain thresholds), bears VAT at the rate of the country in which the consumer lives. The same is true of purchases by, for example, banks. These special cases might be ended under the definitive VAT system. iv) The move to the definitive VAT system might also provide an opportunity to make further progress in ensuring a uniform VAT base in all Member States (i. e. that the same transactions are subject to tax or are exempt from tax). This was the original objective of the 6th.VAT Directive. 8. Legal Basis envisaged by the Commission: Article 99 9. Documentation and sources: see above. Also Enterprise in the Single Market...the definitive VAT regime (European Commission conference papers 27/28 June 1994). Formulation of the definitive scheme imposing turnover tax on the intra-Community trade in goods and services and for a functional clearing procedure (German Bundesministerium der Finanzen). VAT and Excise Duties: Changes in Cross-Border Purchasing Patterns Following the Abolition of Fiscal Frontiers on 1 January 1993 (Price Waterhouse for DGXXI/C-3, August 1994). Single Market Policy Evaluation: esp. VAT and Intrastat (UK Customs and Excise). 10. Background information: Discussions within the ECOFIN Council have already taken place on the basis of papers from its ad hoc Working party on VAT. There is a consensus on the main criteria which the definitive system must meet, namely: - fewer administrative obligations and fundamental simplification of taxation; - no reduction in Member States' income from turnover tax; - no increased risk of tax fraud; - preservation of the neutral effect of turnover tax on competition. ECOSOC has also published its opinion on the functioning of the Internal Market, including the VAT situation (Connellan Report). It concludes, among other things, that "the application of VAT at destination rather than at source causes trade distortions due to different rules for local products"; and also that "the transitional VAT system does not operate in a satisfactory manner...Different VAT rules in Member States create substantial difficulties". Finally the Commission's Report to the Council on the functioning of the transitional system of Value Added Tax on intra-Community transactions is likely to be officially published in the middle of November. Draft versions of the text observe that the transitional system has achieved its main objectives: - to permit the abolition of frontier controls for the purpose of collecting VAT; while, at the same time - allowing Member States to retain, in large measure, their fiscal sovereignty. This does not mean, the Commission nevertheless observes, that the present system "can be considered sufficient to permit the harmonious functioning of the Single Market". It draws particular attention to a number of defects: - traders cannot treat all their transactions within the Community in the same way for VAT purposes; - liability to tax is incurred at locations different from that at which the supplier of is based; - though the VIES system for verifying VAT numbers is working well, companies have faced problems in providing proof that the correct tax has been paid; - the taxation of services, especially transport, and the "special regimes" have been causing particular difficulties; - increasingly, responsibility for the correct payment of Value Added Tax is passing from the supplier to the purchaser; - the resulting complexity of the system is leading to pressure for the general abandonment of the system by which VAT is paid in "fractions" at different stages of the manufacturing/distribution chain. "If this route is followed, the essential nature of the tax will be changed, and it will be transformed, de facto, into a kind of sales tax". Some of the problems, the Commission concludes, can be corrected within the framework of the transitional system. Others, however, will not be solved without radical changes. Effect on SMEs The Commission also draws attention to complaints from traders themselves - particularly from Small and Medium-Sized Enterprises - about the complexity and costs of the transitional system. Some of these, the Commission notes, have been the one-off costs of adaptation. SMEs had found particularly onerous the frequent need to appoint "fiscal agents" in different Member States; and the problems of recovering VAT paid on purchases in other Member States (the 8th. and 13th VAT Directive procedures). But it had also become apparent that "the complaints have been more about statistical obligations than about the requirements of the new VAT system itself". Studies on the effects of the transitional system on firms have also been carried out by the German Finance Ministry (see under Documents and Sources); and by the UK Customs and Excise. The former reached a "predominantly negative appraisal of the transitional arrangements...There has been no real progress for enterprises in turnover tax harmonisation". The latter noted that "many companies have complained about the complexity of the Single Market VAT system. They now have to work with three VAT regimes - domestic, intra-EC and non-EC". As far as Intrastat is concerned, the UK survey found that "many businesses are not fully convinced of the value of completing detailed statistics in a Single

Market". Of the firms surveyed, 28% reported that Intrastat was their prime difficulty in the new Single Market. The main problems were: - the classification of goods, in particular detailed subdivisions of the same product; - differences between VAT and INTRASTAT rules (e.g. dates); - exchange rate complications. However, UK Customs and Excise also noted that "one of the main paradoxes of the Single Market changes relates to Intrastat". Though it was "the main cause of complaints from businesses,....companies and business organizations are the major users of statistics and demand the level of detail provided." Of the 150,000 UK businesses involved in intra-EC trade, only just over 30,000 had a liability to complete the Intrastat declaration.