VAT and Small Business

Citation for published version:

Link:
Link to publication record in Edinburgh Research Explorer

Document Version:
Publisher's PDF, also known as Version of record

Publisher Rights Statement:
© 2015 Luca Cerioni. Published under Creative Commons (CC BY-NC-ND 4.0 International) License

General rights
Copyright for the publications made accessible via the Edinburgh Research Explorer is retained by the author(s) and / or other copyright owners and it is a condition of accessing these publications that users recognise and abide by the legal requirements associated with these rights.

Take down policy
The University of Edinburgh has made every reasonable effort to ensure that Edinburgh Research Explorer content complies with UK legislation. If you believe that the public display of this file breaches copyright please contact openaccess@ed.ac.uk providing details, and we will remove access to the work immediately and investigate your claim.
VAT and Small Business: To the Heart of European Tax Policy?

Author(s): Luca Cerioni

Permalink: http://www.europenfutures.ed.ac.uk/article-1691

Publication: 28 September 2015

Article text:

In this extended article, Luca Cerioni situates the debate on VAT in digital services and small business in the wider context of developments in EU tax policy. He argues that the EU's approach of harmonising rules in some areas of tax and allowing competition in others weakens the single market and that, in the absence of full harmonisation, the EU should encourage bottom-up convergence between national tax regimes.

VAT and Digital Services

The recent change in EU tax law on the Value Added Tax (VAT) rules for supplying 'digital services' to consumers located in other EU Member States has provoked a lively debate. The discussion has transcended this single issue and raised broader questions on the aim of EU tax policy, not only in the area of indirect taxation (like VAT).

In this context, digital services mean 'broadcasting, telecommunications and e-services that are electronically supplied'. In a nutshell, these encompass 'automated digital services' – anything downloadable or used online which is either automated or involves 'minimal human intervention'.

As of 1 January 2015, EU legislation requires businesses selling digital services within the EU to pay VAT in the buyer's country, at that country's rate, regardless of where the seller operates or has its registered office.

Under these new rules, the seller must now be able to prove where the buyer is located. In order to do this, sellers must now obtain two non-contradictory pieces of information which prove, to audit standards, where a sale is made. They must also store this information for 10 years.

Sellers do not need VAT registration in all their customer countries, since 'mini one-stop shop' (MOSS) systems are in place in every EU national tax authority. Under this system, sellers only need to register in their own country and complete their VAT reporting and payment obligations through their national tax authority. That tax authority then distributes the amounts of VAT collected to the tax authorities of the other countries.
UK businesses selling to other EU countries have to register with the VAT MOSS system and submit single calendar quarterly returns to HMRC. Following this, HMRC, on behalf of the seller, sends the relevant information and payments to the tax authorities of the EU countries where customers are based.

The system was set up to create a ‘level playing field’ throughout the EU for consumers in the digital services market. It was also designed to prevent sellers, in particular large companies, from undercutting their competitors by claiming to be based in countries, such as Luxembourg, where VAT rates are lower.

There are wide disparities among the EU’s 28 Member States on how VAT is calculated, including between 75 to 81 different tax rates. In essence, the new rules aim at preventing distortions in the single market that would otherwise exist through inter-jurisdictional ‘tax competition’ in the common VAT area. One might note a similarity with the objective of limiting ‘harmful tax competition’ that the EU has also pursued in the area of direct taxation.

On the latter subject, the EU adopted a Code of Conduct on Business Taxation in 1997. The code was designed to limit ‘harmful tax competition’ brought about by special tax regimes in one Member State (such those offering special reliefs for foreign investors) which result in lost revenue for other Member States. However, the code (at least to date) does not affect ‘fair tax competition’ through tax rates applied to the normal tax base.

Despite the high degree of harmonisation on VAT, the Member States have guarded a wide degree of control of their tax rates, which they consider to be an instrument of competitive tax policy. The absence of tax rate harmonisation (beyond the minimum rates set by EU VAT legislation) has weakened the level playing field that the new VAT rules for digital services are designed to support.

Impact on Small Business

Crucially, these rules did not include any exemptions for small business. Complying with these new requirements has in practice been excessively burdensome for them. Many smaller companies — include some in the UK — have claimed that the rules are so complex that they had to stop selling digital services in other EU countries.

The main obstacles for small business lie in the data collection requirements (two pieces of non-contradictory information) and that many basic e-commerce platforms are not designed for this purpose.

In order to display the correct price (inclusive of VAT), the seller needs to know a customer’s location before the sale. The seller can determine the location by asking customers to fill in extra fields when making their online purchases. However, this process can often lead them to decide to abandon the purchase.

The solution normally rests in major website upgrades, which are expensive and time-consuming, and particularly burdensome for smaller firms. Different interpretations under national law of ‘digital services’ — especially on the ‘minimum
human intervention’ criterion – can make complying with the rules even more complicated.

Conversely, these problems simply do not arise in domestic sales of digital services. Here, small businesses usually benefit from VAT exemptions. In the UK, the exemption amounts to £81000.

Some small business owners set up a campaign group (EU VAT Action) to protest against the new rules. Following from a recent summit of EU finance ministers in Dublin, the Commission announced its intention to propose a threshold to exempt small businesses from these VAT obligations.

Paradoxically, the system designed to avoid VAT–driven distortions in the EU single market and to create a level playing field has, in its first year of application, ended up created just such distortions. The rules have resulted in a de facto barrier to two of the fundamental freedoms – the free movement of goods and services.

In so doing, they undermine the spirit of the common VAT system dating back to its establishment in the 1960s. Although the impact was felt specifically in the digital services market, it has had a significant effect on small business, which represents a sizeable percentage of companies in the EU.

**EU Tax Policy Going Forward**

The introduction of an exemption threshold would certainly remove the new barriers for small businesses. However, the Commission would have to consider whether to propose a uniform exemption threshold. More broadly, the current situation is cause for reflection on a key choice in EU tax policy, going beyond the area of indirect taxation.

The VAT difficulties for small business stem from a vicious cycle driven by the Member States’ unwillingness to fully harmonise tax policy. The VAT Directive does not provide for complete harmonisation of tax rates, since Member States wish to maintain a level of autonomy.

However, the lack of (sufficient) harmonisation between VAT rates in EU countries, together with different national interpretations of the common rules that do exist – in short, the accepted degree of ‘tax competition’ between countries in the VAT area – has created disparities between the countries. These disparities became so salient as to necessitate new rules to ensure VAT is paid in the country of the buyer, which caused great difficulties for small business.

No Member State should have an interest (certainly, not a revenue interest) in seeing a number of its businesses find it difficult to or stop selling in other Member States because of burdensome requirements that arise, ultimately, from differences in national VAT regimes.

These realities should encourage the European Commission and the Member States, once again, to reflect on the dichotomy of simultaneously pursuing tax harmonisation and allowing tax competition. This dilemma has always been a
central issue for European tax policy, both in direct and indirect taxation. The contrast between a high degree of harmonisation in indirect taxation and little harmonisation in direct taxation should not prevent reflection on desirable developments in both areas.

On the one hand, the entire EU tax policy should contribute to the consolidation and proper functioning of the internal market – rather than fragmenting it by allowing excessive differences between national tax systems to remain. On the other hand, some proposals on direct taxation suggest that the jurisdiction for corporate tax purposes should no longer be based on the tax residence of a company, but on the location where its sales take place.

Such an approach would end the ‘forum shopping’ which some companies undertake (eg through transfer of the ‘place of effective management’), changing their country of tax residence in order to take advantage of the wide differences in national corporation tax rates.

It would also link companies more directly to the countries of their market base, which is normally quite stable. Nevertheless, the current VAT situation shows the administrative and reporting difficulties that might arise under this scenario, particularly for small businesses, due (again) to the wide differences between (corporate) tax rates.

Harmonisation would arguably enable Member States to protect their tax revenues more effectively than is the case under tax competition. It would bring about – to the benefit of business – both a level playing field and simplification in tax compliance requirements. In the absence of agreement on tax harmonisation in the Council, the key challenge for the Commission is to propose solutions which, although not legislating (top-down) harmonisation, encourage spontaneous (bottom-up) convergence between the national tax rules of the Member States.

Author information:

Luca Cerioni
The University of Edinburgh

Dr Luca Cerioni is Lecturer in Tax Law at the University of Edinburgh. His research interests include EU tax law, international and comparative tax law. His latest book is The European Union and Direct Taxation: A Solution for A Difficult Relationship (Routledge, 2015).

Publication license:
Creative Commons (Attribution-NonCommercial-NoDerivatives 4.0 International)

Additional information:
Please note that this article represents the view of the author(s) alone and not European Futures, the Edinburgh Europa Institute nor the University of Edinburgh.