

Brave New Digital World

VAT and E-commerce

TIt is predicted that, in 2004, worldwide e-commerce revenues will total \$2.7 trillion.¹ Business to customer sales giving rise to that total are still predominantly 'indirect' purchases (that is, the electronic ordering of tangible goods). Such trade is in principle similar to the traditional mail order industry and creates few new tax problems. The same is not true of 'direct' e-commerce (the electronic ordering and delivery of services), which encourages new forms of cross-border transactions and, as a result, generates novel challenges to the tax system.

The European Commission has noted that *'The global markets that are emerging will no longer be constrained geographically. It will become potentially more difficult to know the location and identity of the parties to the transactions.'*² Other commentators put the position more starkly: *'... it is completely impossible to police this ... (It) is going to be so complex and so diffuse that it's going to be impossible for any national, or even international, authorities to track down these transactions ... (It)'s the ultimate global back-pocket economy ... No tax authorities can keep on top of that.'*³

On a more practical level, before 1 July 2003 most electronically supplied services were subject to VAT in the country of the supplier. Thus, EU businesses charged local-rate VAT on those services to all their customers, including those outside the EU. On the other hand, suppliers outside the EU were not required to charge VAT on supplies to EU customers, resulting in a perceived double competitive disadvantage for EU traders.

Until recently those potential problems were largely academic, as technical difficulties concerning delivery and payment ensured that the volume of direct sales to private individuals was

KPE Lasok QC and Ian Hutton, Monckton Chambers, describe the current state of play with regards to VAT and E-commerce

limited. However, those limitations are quickly being solved and even traditional retail companies are scrambling for a piece of the digital cake (see, for example, the recent launch of Coca Cola's MyCokeMusic.com) and reaping immediate rewards.⁴ Just as importantly, we are finally seeing the long promised hardware devices (in particular 3G telephones) that are capable of providing easy access to this new digital environment.

THE EU'S RESPONSE

In order to create a more level playing field between EU and non-EU digital traders, the EC Council adopted Council

the customer belongs when electronically supplied services are received by:

- a private individual who belongs in the EU from a non-EU business;
- a customer outside the EU; and
- a business customer who belongs in the EU but in a different country from the supplier.

The place of supply remains the place where the supplier belongs when:

- a private customer belongs in a different Member State from his supplier; or
- the customer belongs in the same Member State as the supplier.

When a non-EU company makes a sale to an EU customer, it must therefore

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Directive 2002/38/EC which, from 1 July 2003, modifies the Sixth Directive for a period of three years. The primary effect of the Directive is that EU suppliers of 'electronically supplied services'⁵ are no longer normally required to account for VAT on supplies to non-EU customers, whilst supplies to non-taxable persons by companies outside the EU are taxed in the customer's country.

This is primarily achieved by modifying the place of supply rules. Thus the place of supply is (normally) where

determine the location of that customer and whether or not he or she is VAT-registered. If the customer is registered, the supplier is not required to charge VAT, as the customer will normally account for VAT at his or her national rate under the 'reverse charge' procedure. If the customer is not registered the company must charge and account for VAT. In order to facilitate those arrangements, non-EU suppliers are theoretically required to register for VAT in every Member State where they supply services. However, a special scheme allows registration in one

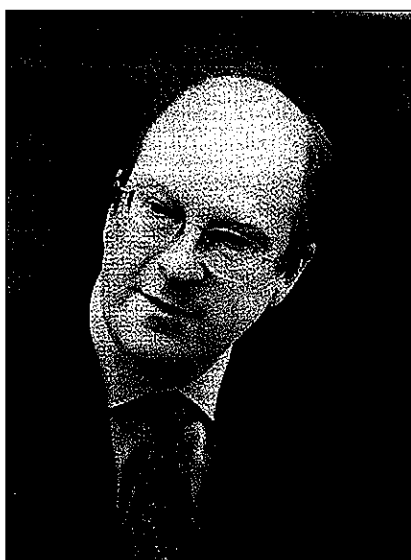
Member State, which will act as a central collection point from which tax is distributed.

HAVE THE PROBLEMS BEEN SOLVED?

As yet, the new arrangements have not yet created much in the way of litigation. It is, however, possible to start identifying areas that may lead to disputes both in the courts and between the various States involved.

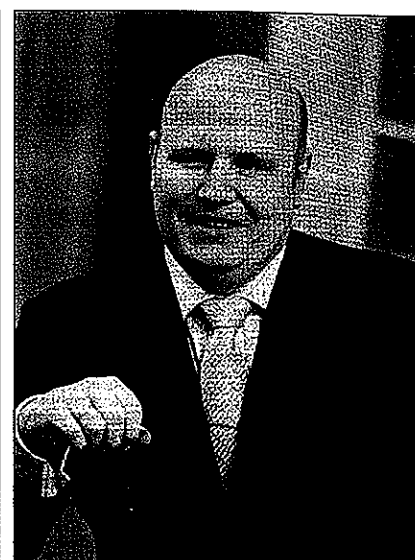
Shopping for the lowest rate

Freeserve, a UK-based Internet service provider, recently brought judicial review proceedings against Customs & Excise in respect of the VAT treatment of Internet service packages.⁶ Freeserve was required to account for VAT on its supplies of services to customers. AOL, classified as a content (as opposed to telecommunications) provider based outside the EU, did not charge VAT. Freeserve took the view that this 'loophole' was saving AOL £40 million per year and argued that AOL was liable to account for VAT because its Internet service package was in fact a principal supply of telecommunications services together with ancillary services: *Card Protection Plan Ltd v Customs and Excise Commrs* (Case C-349/96) [1999] STC 270. Freeserve further contended that, in deciding whether or not to assess AOL, the Commissioners had wrongly taken into consideration the imminent effect of Directive 2002/38. The Court held that



KPE Lasok QC

*practices as they are a misuse of the derogations which were granted solely to allow the Member States concerned to take account of the remoteness and special geographical situation of those regions.*⁷ Freeserve's attitude was relaxed: a spokeswoman took the view that 'the current situation isn't likely to change for years to come'.⁸ Indeed, the Commission's objection is relevant only to exceptional arrangements, such as those that apply specifically to Madeira, and has no application to situations where there is a general disparity between the rates charged in different Member States.



Ian Hutton

intervention'¹¹ (whereas correspondence courses are specifically excluded¹²) and have argued that there is no substantive difference between virtual and real classrooms or between learning without human intervention via a correspondence course and the same process on-line. For its part, the Commission has stated that paper books and e-books are 'fundamentally different products', justifying the zero-rating of the former and the standard-rating of the latter.¹³ That approach is similar to making a distinction of principle between a song purchased and listened to on CD and one downloaded and enjoyed on an MP3 player. They are fundamentally the same products, only the means of delivery and enjoyment are different.

Equality

Some US traders have taken the view that the new system is in breach of the OECD's principles of tax neutrality in that it applies even to small US businesses (which would not need to be registered in the EU). Equally, non-EU businesses cannot deduct any input tax they do incur at the same time that they account for output tax on sales. The tax is also said to be disproportionate, with one business estimating that, in any given year, it would spend \$1,000 to collect \$100 of VAT.

In similar vein, the VAT rate applicable to a sale of, for example, software by a US company to a private customer in the UK is 17.5%. On the other hand, the sale of the same software to the same customer by a company established in Madeira will be charged at the local rate of 13%.

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the effect of the new legislation was a relevant consideration and that the Commissioners had applied an appropriate test in classifying AOL's services.

Partly in response, Freeserve has now decided to move its broadband service to Madeira (thus charging its private customers 13% VAT), a decision which it is said will save the company £4.5 million per year whilst depriving the UK Exchequer of £17.5 million. Unsurprisingly, larger US e-commerce companies are also being advised to establish in one of the lower-tax Member States. The European Commission responded to this trend by saying 'Steps must be taken to put a swift end to such

Interpretation

In broad terms, electronically delivered services will be those which are:

- reliant upon an electronic network for their provision; and
- essentially automated, involving minimal human intervention.⁹

That approach is intended to ensure that, where networks are used simply as a means of communication, the underlying service is not regarded as electronically supplied. However, it is easy to see that some anomalies will be created. Thus, other commentators¹⁰ have noted that electronic services include 'Teaching that is automated and dependent upon the Internet ... including virtual classrooms' and 'workbooks completed without human

Extra-territoriality and enforcement

The most significant feature of the new arrangements is the attempt to impose VAT on businesses over which the EU has no jurisdiction. Unsurprisingly, this approach has not been wholeheartedly embraced by foreign, and in particular US, businesses: *'The implementation has skewed the playing field in favour of EU companies, while putting a significant burden on US businesses that do not benefit from the tax'*.¹⁴ The new tax is also said to be in breach of the 14th Amendment¹⁵ to the US Constitution and various Supreme Court decisions: in particular *Quill v North Dakota* (504 US 298 (1992)) in which it was decided that North Dakota tax could not be imposed upon a mail order company that had no physical presence in that State.

As a result, US companies have organised the 'Teabag Campaign', under which they are encouraged to lobby US senators and congressmen against the imposition of VAT. If campaigns of this kind gather momentum, it is reasonable to assume that some businesses will decline to collect VAT. This, of course, raises the question of enforceability. In many ways the new system is remarkable. It attempts to impose a self-assessed tax on transactions which are extremely difficult to monitor and without any easily applicable sanction against those who refuse to register or collect the tax.

It seems likely that large companies with substantive links to the EU (for example, assets within the Member States) will comply with the Directive. However, the position with regard to smaller enterprises is less clear and the limited surveys that do exist suggest that compliance in the US is thus far patchy to say the least. It has been suggested that companies that fail to comply should lose EU intellectual property protection. A more radical suggestion is that directors of non-compliant companies could be arrested if they visit Europe. Without such strong measures, extra-territorial compliance could wither on the vine. However, if the tax authorities do take a proactive approach, it seems entirely possible that other countries will decide that EU companies which supply into their territories should also be responsible for collecting local sales taxes. Piecemeal action of that kind could greatly increase the complexity, costs and administrative burdens arising out of transnational e-commerce.

Conclusion

It is clear that the EU introduced Directive 2002/38 partly in order to set the agenda in the developing digital marketplace. However, it is arguable that, by acting without clear international agreement, the EU has made a coherent international framework more difficult to achieve. Some commentators have suggested that, in the absence of such agreement, US firms (particularly small suppliers of specialist services) will decide not to sell to the EU, thus hindering the development of online commerce. Whether or not that is correct, it seems

Notes

- ¹ Emarketer.com.
- ² *E-commerce and Indirect Taxation*, Communication by the Commission.
- ³ Eamonn Butler, The Adam Smith Institute.
- ⁴ Apple's iTunes music site has sold 25 million songs in its first 9 months of operation. As a result, it is being predicted that CD singles will be phased out within three years.: Emmanuel Legrand, Bureau Chief for Billboard Europe, BBC 15 January 2004.
- ⁵ Including the supply of websites or web-hosting services; downloaded images, text

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likely that many companies will simply ignore the requirement to pay VAT and that other jurisdictions will see the EU's actions as an invitation to extend the scope of their own local sales taxes. At best this will lead to increased complexity for those who wish to trade online; at worst it could create significant trade disputes.

In the past, both the UK and the US have suggested that one could boost online commerce and create a level playing field by simply removing sales tax on digital supplies. It remains to be seen whether the EU's chosen approach is an equally effective means of achieving

or information, including making databases available; downloaded software; digitised books or other electronic publications, downloaded music, films or games; electronic auctions; internet service packages.

⁶ *R (on the application of Freeserve.com plc) v Customs and Excise Commissioners (America Online Inc, interested party)* [2003] EWHC 2736 (Admin).

⁷ 'EU mulls closure of Madeira ISP tax loophole' *The Register*, 23.7.03; COM (2003) 397.

⁸ Tax-News.com, 30 July 2003.

⁹ *Customs & Excise Information Sheet 04/03*.

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those aims or simply a flawed attempt to raise revenue from those who are willing to pay.

SIXTH DIRECTIVE

We will be publishing a special issue on the future of the *Sixth Directive* in June, which Paul Lasok will be contributing to and supervising. If anyone is interested in having an article published on this topic in this special issue, could they please contact the Editor on Alison.Lovejoy@lexisnexis.co.uk.

¹⁰ Chowdhary 'Internet, EU VAT & Educational Services' *The Tax Journal*, 2003 693, 17.

¹¹ Customs & Excise Information Sheet 04/03, Table 1, item 5.

¹² Table 2, Item 3.

¹³ Commission 7/05/2002, IP/02/673.

¹⁴ Housley 'VAT & How the E-commerce Companies are Coping', Softwaremarketingresource.Com.

¹⁵ 'No state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any state deprive any person of life, liberty, or property, without due process of law.'