

New European Union rules for taxing on-line sales

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Summary

The European Union's (EU) fifteen member states have reached unanimous agreement on new rules that are set to change the way that Value Added Tax (VAT) is applied to sales of digital products and services over the Internet. The current system allows US based suppliers to sell things like down-loadable software to EU final consumers without charging VAT; the proposed changes would require they do. VAT is ultimately paid by consumers but once it is included in the final price the cost of a US supplied electronic service to that consumer could rise by as much as 25%. The Council Directive¹ setting out the system will amend a key piece of VAT framework legislation² that dates from 1977 by clarifying how VAT should be charged on electronically supplied and radio and television services. From 1 July 2003 US based companies selling and delivering services on line to EU customers will have to register for VAT purposes with one Member State. They must collect the tax on all sales at the rate applicable in the consumer's country, submit quarterly VAT returns, and remit all VAT revenues to the Member State of registration. This report looks at what the new rules mean for US based companies, why the EU is introducing them, and sets out some of the concerns that have been raised by industry and the USG.

1. The new rules - key points

- Digitally delivered goods and services consumed within the EU will be subject to VAT, irrespective of whether they are supplied from within or outside the EU.
- When these goods and services are consumed outside the EU they will not be subject to VAT.
- The proposal does not target goods and services that are ordered on line but delivered through off-line channels – e.g. software in CD format
- It also does not cover business to business transactions
- A special registration scheme is included for third country suppliers to facilitate their compliance (see point 4)

2. What will the changes mean for US businesses?

a) For US based businesses

- **selling to EU based businesses – there's no change.** Their customers would continue to be responsible for VAT accounting and the supplier would not need to register for VAT in the EU
- **selling to EU final consumers – there is a change.** They will have to register for VAT in one of the EU's fifteen Member States and use the special

¹ http://europa.eu.int/comm/taxation_customs/taxation/ecommerce/council%20directive.pdf

² http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=31977L0388&model=quichett

scheme to collect VAT on all sales of digital products and services to consumers within the EU.

b) For US businesses *established in the EU*

- **selling to EU based business – there is no change.** Responsibility for VAT accounting on the sale would stay with customer.
- **selling to EU final consumers – there is no change.** A US firm established in France and selling to a UK customer would continue to charge French VAT rates on the digital products and services supplied.
- **selling to all customers outside the EU – there is a change.** VAT would no longer be levied for these products and services.

3. What types of products and services are targeted?

The Directive applies to electronically delivered services as well as radio and television broadcasting services. The first category includes digital products that are distributed over the Internet such as software. The EU treats all products that are distributed electronically as services. An annex to the proposed legislation sets out an illustrative list of the type of services that are targeted by the new framework.

- Web site supply, web hosting, distance maintenance of programs and equipment
- Supply of software and updating thereof
- Supply of images, text, information and making databases available
- Supply of music, films and games, including games of chance and gambling games, and of political, cultural, artistic, sporting, scientific and entertainment broadcasts and events
- Supply of distant teaching

There would be no tax to collect on free downloads, free information or free access to the Internet as VAT is not generally a consideration when no charge is made. The European Commission also pointed out in an accompanying note to its original proposal that nothing will change in respect of services where the Internet is only used as a channel of communication between the supplier and the customer. For example sending legal advice by email does not change the nature of a lawyer's services.

4. What is the “special scheme” for suppliers based outside the EU?

Non-EU based suppliers can choose which EU Member State (MS) tax authority they deal with for VAT purposes. They must then register with that authority by providing information including name, postal and electronic addresses, web sites, national tax number and a statement that the company is not already identified for value added tax purposes in the EU. The chosen tax authority will then provide the supplier with a dedicated number by email after which the supplier must submit a quarterly VAT return that includes details on the total value of sales and tax collected in each MS. The supplier remits tax collected to the tax authority that is then responsible for reallocating the VAT revenues among other the other MS. Under the scheme third country suppliers must make tax records available to MS of where they register and

those MS where their consumers reside. They should keep such records for ten years after the sale.

Member States have agreed that this system should be applied for three years following implementation of the Directive and then be extended or revised. According to the European Commission: "the single registration model offers a streamlined set of obligations which can be easily completed online without the need for a fiscal representative or for any physical presence"

5. Why are the rules changing?

The main reason is to correct a system that, from the EU perspective, discriminates against EU based suppliers of digitally delivered goods and services in two ways. First, these companies have to charge VAT on electronically supplied services to consumers outside the European Union, their third country based competitors clearly do not. Second, they have to charge the VAT rate applicable in their country of establishment on these services to consumers within the EU; their third country based competitors do not. The new rules would correct this by introducing a partial country of consumption system. All such supplies consumed within the EU shall be subject to VAT whereas all those consumed outside shall not.

6. When will the new rules apply?

The new system will be valid across the EU from 1 July 2003. Although the new regime has been agreed unanimously by Member States, it still needs to be formally signed off. The reason for the delay is that the Directive is accompanied by a Regulation covering cooperation between EU countries on the reallocation of VAT revenues, which underpins the special scheme for third country suppliers. The Regulation had been held up because of an EU procedural technicality. The Commission argued that it was single market measure and that as such it should be subject to a qualified majority approval vote rather than unanimity. The Member States consider it a tax measure and argue that it must be approved on a unanimous basis. The Council could not give final approval to the Regulation until the European Parliament had given its non-binding opinion on the legal basis. It did so at the end of last month and now the way is clear for the Council to sign off the proposal as an "A" point (i.e., without discussion) at any forthcoming ministerial council. This may seem rather an odd process to EU outsiders but it is part of the regular sparring that goes on between the different institutions. At its core is the ongoing tension between Community and Member State competence. Once approved it will be down to Member States to put in place the mechanisms to make the system workable from July next year.

7. The debate surrounding the Directive

- What digital goods and services are covered? The proposal includes an illustrative list that is by definition not comprehensive. Expect more details during the implementation phase up to July 2003.
- How can the consumer's jurisdiction be accurately identified? To assess which Member State rate is applicable to the sale US suppliers are going to have to be able to verify their customers' identity (business or final consumer) and jurisdiction in a real-time, on-line environment. Many companies have stressed that the technology is not yet available to do achieve this with 100% accuracy

- Won't US based suppliers face a more onerous compliance regime than their EU based counterparts? The US Treasury has argued that they could because while a European company will be able to charge the same tax rate to every European customer, U.S. businesses will have to calculate the tax rate for each European customer who buys a download, based on the country they live in. The EU has argued that the special scheme is its best effort at lightening the compliance regime.
- Won't US companies sometimes have to charge more VAT than their EU based competitors? Yes, sometimes. Take the example of a US based supplier and its Swedish competitor selling digital products to a Spanish consumer. The US company would have to charge the VAT of the jurisdiction of the consumer - the Spanish VAT rate is 16%. The Swedish competitor has to charge the Swedish VAT rate of 25%. Here the advantage falls to the US supplier. On the other hand if competitor were based in Luxembourg (VAT rate 15%) the US supplier would be at a marginal disadvantage.

Conclusion

The European Union's new system for applying VAT to electronically delivered services should be signed off shortly and will take effect across the EU by 1 July 2003. US based suppliers of these types of services to EU based consumers will be directly affected. Prices to their consumers are likely to rise and they will face additional compliance requirements including registering and dealing with an EU based tax authority. The Commercial Service to the European Union will closely monitor the ways in which different Member States implement the new system and flesh out the principles outlined in the Directive. For more information on this EU development and on others that affect the market for ICT products and services contact martin.whitehead@mail.doc.gov. For further information on the services provided by the Commercial Service to the European Union please visit <http://www.buyusa.gov/europeanunion/>

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