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The definitive VAT system--Better the devil you know?

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Tax analysis: Would a definitive VAT regime solve the problems of the current system? Tarlochan Lall, a barrister at Monckton Chambers, advises that neither businesses nor member states have appetite for fundamental changes unless they are necessary for resolving identified defects in the system.

Original news

VAT Expert Group recommendations for EU 'definitive VAT regime', LNB News 17/06/2014 177

The European Commission's VAT Expert Group (VEG) has published a set of broad common principles for establishing the 'definitive VAT system' for intra-EU supplies of goods by 2019. The Commission is considering five alternative taxation models and invites businesses to take part in a survey to help analyse the impact of any changes.

Briefly, what is the background to the publication of the VEG's Opinion?

The essential purpose of the VEG was to give stakeholders, in particular businesses, a voice in the design of the VAT system in which businesses act as unpaid tax collectors. Representatives on the VEG welcomed that opportunity. Member states are not represented on the VEG, although they are represented on another group set up by the European Commission, namely the Group on the Future of VAT (GFV). The VEG, by its opinion, essentially calls for active engagement with member states in devising a system which works for both businesses and member states.

Why is the current VAT system known as a transitional system?

The European Commission's Green Paper issued in December 2010 (see *On the future of VAT--Towards a simpler, more robust and efficient VAT system*, LNB News 01/12/2010 68) stated that ever since the first legislation on VAT was agreed upon at EU level, 'a commitment was taken for the introduction of a VAT system tailored to the single market and operated across member states in the same way as within a single country'. Recitals to the Principal VAT Directive 2006/112/EC recognise that in seeking to achieve that objective 'it is necessary to proceed by stages, since the harmonisation of turnover taxes lead in member states to alterations in tax structure and appreciable consequences in budgetary, economic and social field'. Accordingly, 'it is vital to provide a transitional period to allow national law in specified fields to be gradually adapted'. The Principal VAT Directive therefore makes provision for a transitional system. The Principal VAT Directive goes on to say that the transitional arrangements shall be replaced by definitive arrangements based in principle on the taxation in the member state of origin of the supply of goods or services (art 402).

The title of the Green Paper also disclosed a further aim of achieving simplicity in the VAT system. Essentially, it is recognised that the VAT system has not achieved that aim.

Originally, it was considered that the aims of the VAT system would be achieved through the origin system. However, the Green Paper outlines the difficulties in devising such a system. In short, a 50-year long

ambition was found to be unachievable. It was abandoned and replaced by establishing a system based on the destination of the goods or services, which broadly reflects the current system.

How would a definitive VAT regime differ? Would it solve the problems of the current system?

There is a general consensus that neither businesses nor member states have appetite for fundamental changes unless they are necessary for resolving identified defects in the VAT system. Complexity in the system affects businesses and member states alike. It is one barrier to achieving harmonisation. The scale of VAT fraud within the EU has given rise to an obsessive problem for member states. Businesses too are affected by VAT fraud as the effect of case law of the Court of Justice of the European Union pushes the risk of fraud in their supply chains onto business who should have known about the fraud. The work of the European Commission, VEG and the GFV in devising the definitive system will be to assess what changes are necessary to resolve identified defects in the system. That work will also involve assessing whether proposed changes would solve the problems of the system and whether the revised system will be better.

What, if any, problems might a definitive regime face?

The problems a definitive regime might face have not been fully identified. Key issues are likely to be whether greater use can be made of the reverse charge mechanism or whether the definitive destination system necessarily must involve tax being accounted for and paid in member states where supplies of goods and services are destined. The latter would involve very significant cash-flow implications for businesses and member states. The reverse charge avoids cash-flow problems but may have contributed to the rise of VAT fraud in material ways. An issue for the VEG is whether there is any solution to the tension created by such competing issues.

How easy would it be to implement?

Whether the revised system would be easy to implement also remains to be assessed by the European Commission, VEG and GFV. There is great interest the mini-one-stop-shop being introduced from 1 January 2015 for digital supplies. If that works well, it could well feature prominently in the design of the definitive system.

What are the five alternative options for a definitive regime currently being considered?

The five options being considered are as follows:

- o adapting the current rules while still following the flow of the goods, with the supplier charging the VAT of the member state of destination
- o aligning the rules for the cross-border supply of goods with the rules governing the place of supply of services with the reverse charge mechanism
- o aligning the rules for the cross-border supply of goods with the contractual flow with the supplier charging the VAT of the member state of destination
- o adapting the current rules while still following the flow of goods with the reverse charge mechanism
- o improving the current rules without modifying them fundamentally

The status quo of the current system is a default option should the conclusion be reached that none of the five options is viable.

In your opinion, which option is the best one and why?

There is much to be said for the last option of improving the current rules without modifying them fundamentally--simply on the basis that it would involve the least amount of disruption for businesses and avoid costs of changing systems. In other words, better the devil you know.

A large majority of responses to the Green Paper considered that the current system for cross-border EU trade is not suitable for a single market. Too much complexity in the system and lack of harmonisation also featured as persistent complaints about the current system.

In my opinion, there is also much to be said for aligning the rules for goods and services. Businesses are now familiar with the rules for the cross-border supplies of services introduced in 2010. Although supplies of goods and services are by their nature different, advances in modern technology increasingly appear to erode the differences in the underlying economic transaction leading to supplies of goods and services. I look forward to seeing the outcome of the feasibility and economic evaluation study commissioned by the European Commission on all five options and what it says about aligning the rules on supplies of goods and services.

How long will it be before a definitive VAT regime is implemented in the EU?

At this stage, it is difficult to predict when the definitive VAT regime will be implemented. The interim report of the feasibility and economic evaluation study commissioned by the European Commission is expected in August 2014. The European Commission will have to put forward proposals for a definitive system following consultation with for example the VEG on which, if any, of the five proposals should be adopted before any legislative process begins.

There is merit in following the process. Businesses and their advisers have much to gain in terms of understanding how the current system works. Their feedback into problems they encounter and solutions to those problems which should be considered is vitally important to a constructive and hopefully successful outcome to the process of devising the definitive system.

Tarlochan Lall, a former solicitor turned barrister, is experienced in direct and indirect taxes as advisor and advocate. He is a member of the VEG set up by the European Commission in 2012 and a fellow of the Chartered Institute of Taxation.

Interviewed by Kate Beaumont.

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