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## The European Community's Value-Added Tax System: Analysis of the New Transitional Regime and Prospects for Further Harmonization

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# The European Community's Value-Added Tax System: Analysis of the New Transitional Regime and Prospects for Further Harmonization

By  
Craig A. Hart†

*To further the European Community's goal of abolishing barriers to trade among Member States, the Community adopted a new regime for levying the value-added tax (VAT) on intra-Community trade. This regime is expected to be transitional in nature. The author describes the obligations arising under Community legislation and the prospects for further harmonization of the VAT.*

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† J.D. Candidate, Boalt Hall School of Law, University of California, 1994; B.A., University of California at Berkeley, 1990. This article is dedicated to Professor Stefan Riesenfeld and to Bill and Gloria Hart, without whom this article would not have been written. I am grateful to Tim Bolin for his comments and suggestions on an earlier draft of this article, and to Professor Barry Eichen-green and Reuven Glick for their time, comments, and suggestions on earlier drafts of Part VI of this article.

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I.  
INTRODUCTION

On January 1, 1993 the European Community introduced an interim system of collecting a value-added tax (VAT) applicable only to intra-Community trade.<sup>1</sup> This regime continues the past practice of taxing goods in the country of final consumption (the "destination" principle), which will remain in effect until January 1, 1997, at which time the European Community proposes to replace it with a permanent regime which will tax goods in the country of production (the "origin" principle).<sup>2</sup> The transitional regime is important not only because it will remain in place for at least four years, but also because it establishes the basic principles and mechanisms upon which the permanent regime will be founded, thereby providing an excellent idea of how a fully integrated European Community VAT system may function. Moreover, it represents a major step by the Community to further harmonize indirect tax systems and to abolish tax barriers among Member States in an effort to build a "Single Market."<sup>3</sup>

This article is divided into five main Parts. First, it begins with a brief history of Community efforts to harmonize indirect tax systems. Second, it discusses the origin principle and the factors that necessitated a transitional regime. Third, it discusses the obligations arising under the transitional regime as would apply to the conduct of trade among Member States. This Part also explains the theory underlying the obligations and discusses the problems and expected benefits associated with their introduction. Fourth, it examines the VAT rate structure, which took effect January 1, 1993. Finally, the article concludes with a

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1. The details of the transitional regime are contained in Council Directive 91/680 of 16 December 1991, 1991 O.J. (L 376) 1; Council Directive 92/111 of 14 December 1992, 1992 O.J. (L 384) 47; Council Directive 92/77 of 19 October 1992, 1992 O.J. (L 316) 1. These directives amend the Sixth Council Directive 77/388 of 17 May 1977 on the Common System of Value Added Tax: Uniform Basis of Assessment, 1977 O.J. (L 145) 1 [hereinafter Sixth VAT Directive].

2. The transitional arrangements shall be replaced by a definitive system for the taxation of trade between Member States based in principle on the taxation in the Member State of origin of the goods or services supplied. To that end, . . . the Council . . . shall decide before 31 December 1995 on the arrangements necessary for the entry into force and the operation of the definitive system. . . . The transitional arrangements shall enter into force for four years and shall accordingly apply until 31 December 1996. The period of application of the transitional arrangements shall be extended automatically until the date of entry into force of the definitive system and in any event until the Council has decided on the definitive system.

Sixth VAT Directive, *supra* note 1, as amended by Council Directive 91/680, *supra* note 1, art. 1(22) (adding art. 281), at 17-18.

3. Some commentators have speculated that adoption of the origin principle may be undesirable or unnecessary. If this view prevails, the transitional regime may become the final system. See Peter Jenkins, *Commentary On The Single Market*, INT'L VAT MONITOR, Apr. 1993, at 10-11 (noting that the relative success of the transitional regime thus far "casts doubt on the viability of moving to the origin system proper at the end of 1996" and adds to the "reluctance" of Member States to do so); see also Sijbren Cnossen and Carl S. Shoup, *Coordination of Value-Added Taxes*, in TAX COORDINATION IN THE EC 59, 67-74 (Cnossen ed., 1987) (arguing that although the origin principle eliminates the need for tax adjustments, the destination principle is preferred after weighing benefits, efficiency, fairness, and administrative considerations).

discussion of the prospects for further harmonization via the unification of rates, the abolition of derogations, and the adoption of the origin principle.

## II. HISTORICAL OVERVIEW OF THE HARMONIZATION PROCESS

The Treaty of Rome, signed in 1957, mandates that signatories harmonize indirect tax systems in order to achieve a free movement of goods and services within the common market.<sup>4</sup> The first step was taken in 1960 when the Commission appointed three work groups (the Jansen Committee) and a Fiscal and Financial Committee (the Neumark Committee) to study the problems of harmonization. The work groups jointly published their findings as a single report commonly referred to as the "ABC report."<sup>5</sup> The Neumark Committee published its own report commonly referred to as the "Neumark Report."<sup>6</sup>

Both reports recommended elimination of cascade-type tax systems and replacement with VAT-type systems. Cascade systems assess a simple percentage tax on business turnover. As a product moves along the distribution chain from the manufacturer to the retailer, tax is imposed on the cumulative value at each stage, an amount that includes the previous tax imposed.

There are two major drawbacks to the cascade system. First, the tax varies depending upon the number of stages at which tax is imposed, thereby distorting competition in favor of firms that are vertically integrated. Second, difficulty in accurately calculating the total tax liability frustrates the ability of governments to assess surcharges on imports and provide tax rebates on exports, thereby interfering with the Community's ability to neutralize distortions of competition caused by taxation. This latter problem was particularly important as it undermined compliance with the General Agreement on Tariffs and Trade (GATT) that prohibits both the imposition of domestic taxes and the granting of subsidies on exported products.<sup>7</sup>

The VAT was considered a superior method of taxation. The VAT promotes a better balance of payments by allowing exporters to deduct the full amount of the indirect tax on products, something not possible with a direct tax nor accurate with a cumulative cascade tax. The VAT facilitates ease of administration for governments because it puts the onus on each purchaser to maintain

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4. Treaty of Rome, Mar. 25, 1957, art. 99, 298 U.N.T.S. 11.

5. See COMMISSION OF THE EUROPEAN ECONOMIC COMMUNITY, REPORTS OF THE SUB-GROUPS A, B, AND C (H. Thurston trans., 1963).

6. COMMISSION OF THE EUROPEAN ECONOMIC COMMUNITY, REPORT OF THE FISCAL AND FINANCIAL COMMITTEE IN TAX HARMONIZATION IN THE COMMON MARKET (H. Thurston trans., 1963).

7. Difficulty in calculating the domestic tax charged on a product for the purposes of refund upon export can lead to an uncompetitive export, in the case of underestimation, or a subsidy, in the case of overestimation. The former is prohibited under The General Agreement on Tariffs and Trade (GATT), Oct. 30, 1947, pt. II, art. III, ¶ 2, 61 Stat. A3, T.I.A.S. No. 1700, 55 U.N.T.S. 194 ("the products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied directly or indirectly to like domestic products"). Subsidies are prohibited under *id.* pt. II, art. XVI.

a record of their transactions with suppliers in order to claim a right to deduct the VAT paid.<sup>8</sup> The VAT enhances revenues because it can be applied to a broad tax base comprising both goods and services, it does not depend upon the taxpayer's profitability, and because tax revenues increase with a general rise in prices. Moreover, the VAT has a neutral effect on taxpayers, particularly with regard to consumption versus savings, capital versus labor, and the level of vertical integration. The VAT has, however, been subject to some general criticism regarding its regressive nature, inflationary impact, administrative cost to business, and the fact that it is a "hidden tax" buried in the price of the product.<sup>9</sup>

Among the original six countries forming the European Community, only France had implemented a noncumulative, multi-stage tax system similar to the VAT. Cumulative multi-stage tax systems were utilized in West Germany, Luxembourg, the Netherlands, Belgium, Italy, as well as France.<sup>10</sup> Among later entrants to the Community, Denmark, Ireland, Portugal, and the United Kingdom utilized a single-stage wholesale tax; Greece utilized a single-stage manufacturer's tax; Spain utilized a multi-stage cascade tax; and Ireland utilized a single-stage retail tax.<sup>11</sup>

In 1967, based upon the recommendations of both Committees, the Council adopted the First VAT Directive which required Member States to replace their various systems of indirect taxation with a general tax on consumption. This tax was to be levied exactly in proportion to the price paid for the good or service, regardless of the number of transactions in the production and distribution process.<sup>12</sup> The Second VAT Directive, issued the same day, further specified that the tax should apply to (a) the supply of goods and services within the territory of the country by a taxable person against payment, and (b) the importation of goods. It also provided definitions of terms and details of the structure of the tax.<sup>13</sup>

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8. This arrangement also creates incentives for both parties to comply with the lawful administration of the tax. The purchaser will want records reflecting a purchase price higher than actually paid in order to obtain a greater deduction. The supplier will want to minimize the recorded purchase price in order to minimize his tax liability. ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *TAXING CONSUMPTION* 103 (1988)[hereinafter OECD].

9. VALUE ADDED TAX 91-94 (Price Waterhouse Information Guide, 1979); OECD, *supra* note 8, at 32-33. See *infra* note 204 for discussion of the transitional VAT regime's cost to traders. But see OECD, *supra* note 8, at 202-08 (discussing the administrative costs to government and business, reviewing data, and suggesting that it is unclear whether VAT is actually costlier to business). Defenders of VAT argue that these negative side-effects can be avoided by proper design of the VAT system. See, e.g., Alan Tait, *VAT Policy Issues: Structure, Regressivity, Inflation, and Exports*, in VALUE-ADDED TAX: ADMINISTRATIVE AND POLICY ISSUES (International Monetary Fund Occasional Paper No. 88, 1991); See *infra* note 272 for a discussion on controlling VAT's inflationary effects.

10. OECD, *supra* note 8 at 27-28 (describing tax systems as of January, 1967). For a detailed history of cascade tax systems and the introduction of VAT in France, Germany, Italy, the Netherlands, and the United Kingdom, see VAT, EXPERIENCES OF SOME EUROPEAN COUNTRIES (Henry J. Aaron ed., 1982); THE VALUE-ADDED TAX: LESSONS FROM EUROPE (Henry J. Aaron ed., 1981).

11. OECD, *supra* note 8, at 27-28.

12. First Council Directive 67/227 of 11 April 1967, 1967 J.O. (71) 1301.

13. Second Council Directive 67/228 of 11 April 1967, 1967 O.J. Spec. Ed. 16.

The First and Second Directives were to be implemented in the original six Community countries by January 1, 1970. The Third Directive extended the implementation date to January 1, 1972 for Belgium, which feared inflation, and for Italy, which required more time to implement the necessary legislation.<sup>14</sup> The Fourth and Fifth Directives further extended the deadline for Italy to July 1, 1972, and then again to January 1, 1973.<sup>15</sup>

Under the First and Second Directives, Member States retained great discretion. In particular, Member States applied different tax rates to the same products, granted their own exemptions for particular products, and maintained different administrative procedures. The Sixth VAT Directive of May 17, 1977 was enacted, in large part, to correct the differences that such discretion caused in the Member States' contributions to the Community's resources.<sup>16</sup> The Sixth VAT Directive repealed the Second VAT Directive and provided new rules and more harmonized standards for territorial application, types and places of taxable transactions, chargeable events, rates, exemptions, deductions, and persons liable for payment of tax.<sup>17</sup>

Difficulties in implementing the Sixth Directive resulted in the granting of extensions to Member States. The Ninth Directive extended the deadline for implementing the Sixth Directive to January 1, 1979 for Denmark, Germany, France, Ireland, Italy, Luxembourg and the Netherlands.<sup>18</sup> The Fifteenth Directive allowed Greece to implement the Sixth Directive by January 1, 1986, and the Twenty-First Directive extended that time limit to January 1, 1987.<sup>19</sup>

The Sixth Directive has been supplemented and amended by a series of later directives. The Eighth Directive of December 6, 1979 clarified the regime applicable to refunds for taxable persons established outside the territory of the taxing Member State but otherwise within the Community.<sup>20</sup> The Thirteenth Directive of November 17, 1986 established a refund regime for persons established outside the Community.<sup>21</sup> The Eleventh Directive of March 26, 1980 excluded French overseas departments from the scope of the VAT.<sup>22</sup> The Tenth Directive of July 31, 1984 amended the Sixth Directive's provisions on place of supply for the hiring out of movable tangible property and transport.<sup>23</sup> The Seventeenth Directive of July 16, 1985 supplemented the Sixth Directive with

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14. Third Council Directive 69/463 of 9 December 1969, 1969 J.O. (L 320) 34.

15. Fourth Council Directive 71/401 of 20 December 1971, 1971 J.O. (L 283) 41; Fifth Council Directive 72/250 of 4 July 1972, 1972 J.O. (L 167) 18.

16. Member States remit a portion of VAT revenues to the Community to support the Community budget. Today that portion is 1.4% of total VAT collected. Council Decision 88/376 of 24 June 1988 on the System of the Community's Resources, 1988 O.J. (L 185) 24 (Euratom).

17. See Sixth VAT Directive, *supra* note 1.

18. Ninth Council Directive 78/583 of 26 June 1978, 1978 O.J. (L 194) 16.

19. Fifteenth Council Directive 83/648 of 19 December 1983, 1983 O.J. (L 360) 49; Twenty-First Council Directive 86/247 of 16 June 1986, 1986 O.J. (L 164) 27.

20. Eighth Council Directive 79/1072 of 6 December 1979, 1979 O.J. (L 331) 11.

21. Thirteenth Council Directive 86/560 of 17 November 1986, 1986 O.J. (L 326) 40.

22. Eleventh Council Directive 80/368 of 26 March 1980, 1980 O.J. (L 90) 41.

23. Tenth Council Directive 84/386 of 31 July 1984, 1984 O.J. (L 208) 58.

provisions for various exemptions, but has since been repealed.<sup>24</sup> The Eighteenth Directive of July 18, 1989 abolished certain derogations provided for in Article 28(3) of the Sixth Directive.<sup>25</sup> The Twentieth Directive of July 16, 1985 granted certain derogations relating to farmers.<sup>26</sup>

The three most recent amendments to the Sixth Directive provide the transitional provisions that took effect January 1, 1993. Council Directive 91/680 of December 16, 1991 supplemented the Sixth Directive with the basic transitional provisions.<sup>27</sup> Council Directive 92/111 of December 14, 1992 made substantial refinements to Council Directive 91/680 and introduced simplification measures.<sup>28</sup> Council Directive 92/77 of October 19, 1992 amended VAT rates with a view toward more harmonized rate structures among the Member States.<sup>29</sup>

### III.

#### THE ORIGIN PRINCIPLE AND THE NECESSITY FOR A TRANSITIONAL REGIME

Under the proposed origin principle, a Community seller charges the VAT of his Member State to his purchaser in another Member State and remits that amount to his domestic authority. The purchaser recovers that same amount paid on her own tax return by way of a right to deduction for inputs utilized for economic activity. The purchaser charges the local VAT in her Member State to her own customer and remits that amount on her tax return. Each party deals with its own tax authority, which uses a computerized database to verify the amount and right of deduction. Unlike a VAT levied on the destination principle,<sup>30</sup> no tax adjustments are necessary under the origin principle because Member States do not tax imports and do not provide rebates on exports.

The Commission wanted an origin-based VAT to take effect immediately, but its adoption was resisted for two reasons. First, without equal VAT rates in each Member State, the origin system creates an advantage for firms based in States with lower VAT rates. For example, a firm producing in Spain, subject to a 12% VAT, could sell its product both domestically and throughout the Community with only a 12% charge for VAT. A firm in Denmark, subject to a 22% VAT, would sell the same product both domestically and throughout the Community with a VAT charge of 22%. Thus, the Spanish firm could sell the same

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24. Seventeenth Council Directive 85/362 of 16 July 1985, 1985 O.J. (L 192) 20, *repealed by* Council Directive 92/111, *supra* note 1, art. 1(24).

25. Eighteenth Council Directive 89/465 of 18 July 1989, 1989 O.J. (L 226) 21.

26. Twentieth Council Directive 85/361 of 16 July 1985, 1985 O.J. (L 192) 18.

27. Council Directive 91/680, *supra* note 1.

28. Council Directive 92/111, *supra* note 1.

29. Council Directive 92/77, *supra* note 1.

30. Under the destination principle, exports must be exempt from tax, and tax must be imposed in the Member State of importation. From the perspective of the importing Member State, the imposition of the tax ensures that imported goods compete on an equal footing with domestically produced goods. Since the exporting Member State will subject a good to tax when it is sold domestically before it is known that it will be exported, a tax adjustment is necessary to refund the tax charged to the exporting party so that the good enters the importing Member State tax free.

product at a 10% lower price than its competitors in other Member States that have the same production costs. Still worse, this arrangement creates an incentive for firms to relocate to lower VAT countries and encourages cross-border shopping.

The simple and favored solution to this problem is to equalize tax rates contemporaneously with the introduction of the origin principle. While this process is already underway, it was not available for the January 1, 1993 deadline.<sup>31</sup>

The second problem presented by the origin principle is that States that import more goods than they export suffer a significant loss of VAT revenues, while export-surplus states obtain windfalls. This second problem will prove more difficult to solve.

The Cockfield Report recommended a clearing-house system that promised to solve both problems in one stroke. It recommended a version of the origin principle to be implemented immediately, or at least as soon as the clearing-house could be put in place.<sup>32</sup> Under this scheme, exporters charge the VAT rate of the country of origin. The importer reclaims any VAT paid on his own tax form and then applies his own state's rate to the total value of the good. A clearing-house would be necessary to ensure that the VAT collected by the exporting state and deducted on the importing state's tax form is reimbursed to the importing state. The net effect is to charge a destination-based VAT. This proposal has been criticized for being unduly bureaucratic and costly. It also creates problems for some VAT-exempt entities which would have to pay VAT on imports, but would have little, if any, domestic VAT payments against which to apply deductions.<sup>33</sup>

Since the problems of trade distortion and revenue loss could not be solved given the tax rates and mechanism in place, the Commission decided to retain the destination principle and adopt the transitional VAT regime which took effect January 1, 1993. The regime is based on the deferred payment scheme utilized in the Benelux countries. Under this scheme, Member States neither physically check nor tax goods upon importation from other Member States. Instead, tax is imposed in the importing Member State at regular intervals using cumulative tax forms. This scheme was adopted both to allow elimination of border tax collection and to enable the Community to gradually make the changes necessary for a fully origin-based system. Part VI of this article revisits the revenue and other economic problems that must be resolved if the origin principle is to be adopted.

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31. Council Directive 92/77, *supra* note 1, begins the process of approximation.

32. Cockfield Report, European Communities Commission, COM(85)310 final. For a brief history of the EC debate on the subject of clearinghouse approaches versus other methods, see A. Lans Bovenberg & Jocelyn P. Home, *Taxes on Commodities*, in *TAX HARMONIZATION IN THE EUROPEAN COMMUNITY 25* (International Monetary Fund Occasional Paper No. 94, 1992).

33. Currently, certain tax-exempt institutions and entities are allowed VAT-free purchases domestically. These typically include government agencies, banks, and insurance companies. *See infra* note 60.

IV.  
THE TRANSITIONAL REGIME

This Part describes the transitional regime. Its discussion is divided into three sections. It begins with an explanation of the theory and purpose of the new arrangements. Next, it examines the administrative obligations for a Community trader effecting intra-Community transactions. Since one of the primary purposes of the transitional regime is reduction of barriers to the movement of goods and services, an understanding of these obligations is necessary to assess progress towards this goal. Finally, it addresses the problems arising in the implementation of these administrative obligations and discusses the projected impact of the new regime.

A. *Purpose, Theory, and Basic Concepts of the Transitional Regime*

The basic purpose of the transitional regime is to abolish tax frontiers that present barriers to trade among Member States. The transitional regime moves towards accomplishing this goal by abolishing both customs barriers and the practice of collecting tax at the border for trade between Member States.<sup>34</sup>

Under the transitional regime, the taxpayer in the country of destination will pay VAT on his domestic tax return. Deductions are likewise granted on these forms. Thus, payment of VAT for intra-Community acquisitions is now accomplished using domestic tax forms in a cumulative manner, as opposed to border collection on separate transactions. Similarly, the monitoring of intra-Community trade is no longer based on controls at the internal borders. From January 1, 1993 goods originating within the Community were allowed to pass freely between Member States without the customary paperwork compiled by customs officials at borders. Private firms assumed control over VAT reporting on their own trading. Thus, physical and administrative barriers were removed, allowing greater movement of goods and services within the European Community.

Since the new regime only applies to intra-Community trade and does not apply to goods and services transported from outside the Community, new terms of art have been created to distinguish the two forms of trade and their respective VAT regimes.<sup>35</sup> The terms "importation" and "exportation" now apply

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34. The goal is often expressed as "eliminating tax frontiers," a phrase which is not clear in its meaning. The fourth recital of the Sixth VAT Directive, *supra* note 1, states its objective in this regard as follows: "[A]ccount should be taken of the objective of abolishing the imposition of tax on the importation and the remission of tax on exportation in trade between Member States . . . ."

The transitional regime only eliminates customs barriers. The elimination of tax frontiers really should encompass the elimination of tax-adjustment mechanisms between Member States for intra-Community trade. Although the removal of customs barriers is a noteworthy step, removal of all barriers to intra-Community trade and optimum reduction of VAT administrative costs has not yet been achieved. See B.J.M. TERRA & JULIE KAJUS, *A GUIDE TO THE EUROPEAN VAT DIRECTIVES* pt. I, at 87-88 (1992).

35. The VAT applies to three broad categories of transactions: the supply of goods and services within a Member State by a taxable person acting as such, importation of goods from outside the Community, and intra-Community acquisitions of goods for consideration within the reporting

only to international trade between Community and non-Community traders, which is still subject to taxation and reporting at customs points upon entry into the Community. Transactions between traders in different Member States are now referred to as “intra-Community trade” and are no longer considered international trade in the context of the Single Market.

Shifting the collection of the tax inward to within Member States and greater VAT harmonization also required definitional and conceptual changes in the place of supply and exemptions.<sup>36</sup> A “supply of goods” is defined as the transfer of the owner’s right to dispose of tangible property.<sup>37</sup> The original Sixth VAT Directive grants Member States discretion to define a variety of transactions, such as those involving electricity, as constituting a supply of goods.<sup>38</sup> The transitional arrangements now require that certain transactions be treated as supplies of goods in order to more completely extend the scope of VAT to all goods and services. These are delivery of contract work under circumstances in which the customer provides materials to a contractor for processing or finishing,<sup>39</sup> transfers of goods to another Member State for use in its own business,<sup>40</sup> and goods on consignment where no change of ownership occurs.

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Member State by a taxable person acting as such or by a nontaxable legal person. Sixth VAT Directive, *supra* note 1, art. 2. The amendments to the Sixth VAT Directive in 1991 and 1992 created distinct obligations for intra-Community transactions.

36. The text states the general rule for place of supply. A number of specialized rules exist. For instance, for supplies to passengers on board ships, aircraft and trains, the place of supply is the point of departure. *Id.* art. 8(1)(c) as amended by Council Directive 92/111, *supra* note 1, art. 1(4). For place of supply in the case of distance sales, see *infra* note 72.

37. Sixth VAT Directive, *supra* note 1, art. 5(1). Note, however, that goods dispatched on consignment, without the transfer of ownership, may also be considered a supply of goods depending upon the domestic law of the Member State.

38. See *id.* art. 5.

39. *Id.* art. 28a(5)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 7. The supply of contract work is to be treated as a supply of goods when: supply by a contractor under a contract to process or finish materials is provided by the customer for this purpose; the work is physically carried out in a Member State other than where the customer is identified for VAT; materials used by the contractor must be dispatched or transported to him by or on behalf of the customer; the materials must be dispatched from the Member State in which the customer is identified for VAT; and the finished goods must be transported or dispatched to the customer and to the Member State in which the customer is identified. This supply refers to the service of processing materials as a good. The actual product produced as a result of this service is treated separately. *Id.* art. 5(5). The latter would be an “actual” supply of goods, as opposed to a “deemed” supply of goods.

40. *Id.* art. 28a(5)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 7, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 51. Such a transfer of goods is commonly referred to as a transfer by an undertaking or self-supply. They are included as supplies in order to avoid distorting trade to the disadvantage of firms that would have to obtain these same supplies from third parties. The transfer of goods by an undertaking is to be treated as a supply of goods when: the goods are tangible property, transported or dispatched by or on behalf of other taxable persons, and transported to another Member State, for the purpose of his own undertaking. The following purposes do not satisfy the last condition: where the goods are installed or assembled by or on behalf of the supplier when the goods are supplied in the Member State for this purpose; where the transfer is subject to distance selling rules; where the transfer is utilized during transport to supply passengers on board ships, aircraft or trains; for the purpose of making an exempt supply as defined by Article 15 or 15a(a) (exports from the community and exempt intra-Community supply of goods; see *infra* notes 43-51 and accompanying text); for the purpose of supplying contract work to

These are often referred to as "constructive," "fictitious," or "deemed" intra-Community supplies.

In the context of VAT, the term "exempt supply" simply means that goods or services are taxed in the Member State of destination. The exemption ensures that tax is only imposed at destination upon the person acquiring the goods, and not at the border. The taxable event for the purchaser occurs when the intra-Community acquisition of the goods is made.<sup>41</sup>

The transaction in the Member State of departure is exempt when three conditions are met. First, the goods must be transported from the Member State of departure to another Member State. Second, the person acquiring the goods must be a nontaxable legal person acting as such or a taxable person. Third, the customer must be liable to account for VAT in that other Member State.<sup>42</sup> It is important for the trader to be aware of his customer's VAT status by obtaining the VAT registration number from the customer or from his domestic authority. If the purchaser in another Member State is a nontaxable person or lacks a VAT registration number, the seller should charge that person VAT at the seller's domestic standard rate and maintain separate accounting records for the transaction.

Exempt treatment for intra-Community supplies is applicable to goods and services including the right to dispose of tangible moveable property;<sup>43</sup> electricity, gas, heat, and refrigeration;<sup>44</sup> deliveries of contract work performed in a Member State other than where the customer is identified for VAT;<sup>45</sup> supplies of new means of transport;<sup>46</sup> certain supplies of goods subject to excise duties;<sup>47</sup> and transfers of goods by a taxable person from his undertaking to another Member State when made on behalf of another taxable party.<sup>48</sup> This exemption extends to the supply of intra-Community transport of the above goods<sup>49</sup> and services ancillary to intra-Community transport, such as loading,

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a taxable person; for temporary use of the goods in another Member State for the purpose of supplying a service; and for temporary use of the goods not exceeding 24 months.

41. *Id.* art. 28d(1), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 10. The tax becomes chargeable only on the 15th day of the month following the month during which the taxable event occurs. *Id.* art. 28d(2). However, in cases where the invoice is issued before the 15th day of the month following that during which the taxable event occurs, then the tax becomes chargeable on the issue of that invoice. *Id.* art. 28d(3)&(4) as amended by Council Directive 92/111, *supra* note 1, art. 1(14) & (15).

42. *Id.* art. 28c(A), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 9, and by Council Directive 92/111, *supra* note 1, art. 1(12).

43. *Id.* art. 5(1). While exempt treatment of moveable tangible property is mandatory, Member states are given discretion to extend the exempt supply status to interests in immovable property, rights in rem over immovable property, and shares or interests giving rights in immovable property. *Id.* art. 5(3).

44. *Id.* art. 5(2).

45. *Id.* art. 28a(5)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(12) at 51.

46. *Id.* art. 28c(A)(b).

47. *Id.* art. 28c(A)(c), as amended by Council Directive 92/111, *supra* note 1, art. 1(12) at 51.

48. *Id.* art. 28c(A)(d), as amended by Council Directive 92/111, *supra* note 1, art 1(12) at 51.

49. The exemption is extended in cases of intra-Community transport of services under circumstances where a special mechanism known as the reverse charge is applied. In the absence of the reverse charge, the place of supply is the place of departure of the transport. The effect is that

unloading, and handling of goods,<sup>50</sup> and the services carried out by intermediaries that are directly related to exempted supplies, such as in the case of brokers and agents.<sup>51</sup>

The exemption is coupled with a right to a deduction for taxable parties who utilize the goods or services in an economic activity.<sup>52</sup> This ensures that the incident of taxation is borne by the final consumer.

For intra-Community trade, traders are permitted to take their deductions in the same period in which the purchase of the input takes place.<sup>53</sup> Similarly, VAT is assessed on all supplies during the same period in which they were effected. Thus, inputs and sales do not need to be matched. This disaggregation of inputs and sales means that in any given period, a higher than normal

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taxation will take place from the place of departure and for the distance covered. *Id.* art. 28b(C)(2), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 8. The reverse charge applies under *id.* art. 28b(C)(3), in cases where the customer is identified for VAT in a Member State other than the place of departure. In that case, the place of supply shall be the other Member State, provided that the taxpayer received goods under that Member State's VAT number and the customer is liable for the tax. Member States may hold the supplier jointly and severally liable for the VAT. *Id.* art. 21(1)(d) as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12.

50. The exemption is extended in cases of services ancillary to intra-Community transport of goods through the reverse charge. In the absence of the reverse charge, the place of supply is the place where those services are physically carried out. The reverse charge applies under *id.* art. 28b(D), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 8, in cases where the customer is identified for VAT in a Member State other than where the services are physically performed. In such cases, the place of supply shall be that other Member State provided that the taxpayer received goods under that other Member State's VAT number and the customer is liable for the tax. Member States may hold the supplier jointly and severally liable for the VAT. *Id.* art. 21(1)(d), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12.

51. The exemption is extended in cases of intermediary services performed on intra-Community transport of goods through the reverse charge. There are three types: supply of transport, supply of services ancillary to transport, and a residual category of all other intermediary services. The regime of supply of transport by an intermediary follows the same regime for supply of transport discussed *supra* note 49. See the Sixth VAT Directive, *supra* note 1, art. 28b(E)(1), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 9. The regime of supply of services ancillary to transport by an intermediary follows the same regime for supply of ancillary services discussed *supra* note 50. Sixth VAT Directive, *supra* note 1, art. 28b(E)(2), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 9. For all other services provided by intermediaries, the place of supply shall be the place where the transactions are carried out in the absence of the reverse charge. *Id.* art. 28b(E)(3), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 9. The reverse charge applies in cases where the customer is identified for VAT in a Member State other than where the intermediary services are performed, then the place of supply shall be that other Member State provided that the taxpayer received goods under that other Member State's VAT number and the customer is liable for the tax. Member States may hold the supplier jointly and severally liable for the VAT. *Id.* art. 21(1)(d), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12.

52. See *infra* note 86 for discussion of "economic activity."

53. Sixth VAT Directive, *supra* note 1, art. 18(2). Note that for occasional transactions involving new means of transport and supply of buildings and unimproved land, the right to deduction may only be exercised at the time of supply. Spain and Italy are authorized to derogate from the immediate deduction regime pursuant to Council Directive 92/111, *supra* note 1, art. 2, at 56. The right to deduction may be delayed by no more than a month, or where quarterly returns are filed, no later than the next quarter. By its own terms, this derogation expires and may not be extended past December 31, 1994.

purchase of inputs could result in a tax refund. In periods where VAT assessments exceed deductions, a remittance of VAT is required.<sup>54</sup>

The right to an immediate deduction recognizes that inputs are fungible and that increased accounting costs would result if tracking the cost and movement of inventory were required. The immediate deduction prevents distortions in costs among traders who have different periods for inventory turnover by equalizing the period of time the trader must finance the tax burden. This system also facilitates Community traders in their calculating VAT liability or credit for any given period.

The exemption and right of deduction are only applicable if the taxable party is subject to the general VAT obligations described below. Deviations from this general scheme depend on the status of the acquirer and nature of the transaction. More specifically, the exemption with a right to deduction is not available to parties who are not subject to VAT because they qualify for and elect to exercise their right to a special scheme for small undertakings or for a derogation from the general reporting obligations of the VAT scheme.<sup>55</sup>

The special scheme for small undertakings allows Member States to provide a simplified tax collection method and graduated tax relief for small businesses that find the general VAT obligations unduly burdensome. This scheme is available to businesses that have an annual turnover that is less than the ceiling set by the Member State in which they are registered.<sup>56</sup> In the United Kingdom, for instance, this threshold was just recently raised to £45,000 from December 1, 1993.<sup>57</sup>

Derogations from VAT administrative obligations are provided for flat-rate scheme farmers,<sup>58</sup> nontaxable legal persons,<sup>59</sup> and taxable legal persons who

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54. In the case of capital goods, a special regime is available to Member States that allows depreciation over five years, either from the date of purchase or first use as required by the individual Member State. Member States may adjust the period of depreciation upward to ten years in the case of immovable property acquired as capital goods. Sixth VAT Directive, *supra* note 1, arts. 19(2), 20(2)-(5). Traders should consult their domestic legislation for the applicable definition of capital goods, the amount of VAT to be held over for later periods, and administrative provisions.

55. *Id.* art. 28c(A)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 9.

56. *Id.* art. 24(2), at 17-18. Pursuant to Council approval, Member States may grant or retain exemptions from the general scheme in the form of simplified procedures for tax collection and graduated tax relief. For a grant of simplified tax procedures, the ceiling is a maximum annual turnover of 5,000 ECU at the conversion rate as of May 17, 1977, the day the Directive was adopted. *Id.* art. 24(2)(b). For retention of simplified procedures, the exemption may be increased up to 5,000 ECU, or if the exemption already applied is for entities with turnover greater than 5,000 ECU, the threshold can be increased as necessary to maintain its value in national currency. This form of tax relief may not be applied to occasional transactions or to the supply of new means of transport. Member states have discretion to exclude other transactions. *Id.* art. 24(3), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 16, and by Council Directive 92/111, *supra* note 1, art. 1(21), at 54.

57. Other Member States are expected to raise their small undertakings thresholds to the equivalent of the British standard. *HM Customs & Excise Release*, No. C & E 1 (Nov. 30, 1993); *Budget Notice BN 76/93*. See *infra* Appendix D for small undertakings thresholds in Member States.

58. Sixth VAT Directive, *supra* note 1, art. 28a(1a)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 5, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 51.

carry out supplies of goods or services for which VAT is not deductible.<sup>60</sup> These derogations apply provided that the intra-Community acquisitions of the above-named parties do not exceed a threshold set by the individual Member State that is not to be less than 10,000 ECU during the calendar year, and did not exceed that threshold during the previous calendar year.<sup>61</sup> In determining whether a trader has exceeded the threshold, the VAT charged on acquisitions, acquisitions of new means of transport, and acquisition of goods subject to excise duties are excluded from the calculation.<sup>62</sup>

In addition, a rather specialized derogation is provided for the supply of ships and aircraft, their fueling, and the supply of goods under diplomatic and consular arrangements. These specialized derogations apply without regard to calendar-year value thresholds.<sup>63</sup>

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Flat-rate scheme farmers, a term covering agriculture, forestry and fisheries businesses, are subject to the simplified flat-rate tax collection procedure provided for in *id.* art. 25, as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 16. Instead of taking deductions for VAT paid on acquisitions, a process which would require registration and impose the other burdens of VAT administration, the farmer recovers VAT paid on acquisitions that are used for the purpose of farming based on a flat-rate devised by the individual Member States.

59. *Id.* art. 28a(1a)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 5, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 51. "Nontaxable legal parties" include public bodies comprised of state, regional and local government authorities and other bodies governed by public law as defined under *id.* art. 25, as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 16. Nontaxable parties also include parties not engaged in economic activities within the meaning of Article 4. This latter category may include transactions taking place within a single organization or group, such as transactions between a holding company and its subsidiary. For instance, in Case 60/90, Polysar Inv. Netherlands B.V. v. Inspecteur der Invoerrechten en Accijnzen, [1991] E.C.R. 3111, the European Court of Justice ruled that a holding company which held an interest purely as an investment, without taking any active part directly or indirectly in the management of the subsidiary company did not engage in economic activity within the meaning of Article 4 of the Sixth VAT Directive because the company did not act as a producer, trader or person supplying services. Thus, Polysar was not permitted to register and deduct VAT paid on intra-Community acquisitions relating to the purchase and sale of the subsidiary's stock.

60. Sixth VAT Directive, *supra* note 1, art. 28a(1a)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 5, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 51. Taxable persons who are not entitled to deductions for their intra-Community acquisitions are those persons who only supply goods and services that do not give rise to any right to a deduction because they are exempt under *id.* art. 13, provided that *id.* art. 17(3)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 11, is not applicable. Article 13(A) of the Sixth Directive exempts supplies made in the public interest such as medical, post, basic public services, and cultural and charitable. Article 13(B) exempts supplies such as insurance, leasing and letting of certain immovable property, and a number of transactions related to the provision of credit, stock exchanges, financial institutions, gambling, supply of certain buildings and land. In addition, Article 13(B), through Annex F, exempts transactions such as those involving sporting events, burial services, and transactions in gold for industrial use. Article 17(3)(c) grants a right to deduction for certain transactions where the customer is established outside the Community or when these transactions are directly linked with goods intended for export outside the Community.

61. *Id.* art. 28a(1a)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 5, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 51. See *infra* Appendix A for Member State Thresholds.

62. Sixth VAT Directive, *supra* note 1, art. 28(a)(1a)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 5, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 51.

63. *Id.* art. 28(1a)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 5, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 50.

For traders engaged in providing "new means of transport," the above derogations are not available and Member States will individually specify regimes for VAT registration.<sup>64</sup>

Traders that exercise their option to be subject to a special scheme, such as for small undertakings, and do not participate in the general VAT scheme are properly understood to fall outside of the system. The general rule for entities exercising their option is that they pay VAT in the Member State of origin. They are not permitted to claim a deduction for the VAT paid on their inputs, nor are they permitted to charge VAT on their sales; thus, the need for regular VAT administrative obligations is obviated. Since no VAT deduction is allowed to these entities, the trader will presumably pass the cost of the undeducted tax on to the consumer.<sup>65</sup>

There is also a great incentive for the special scheme trader to purchase supplies in Member States where the VAT is lowest. In the case of flat-rate scheme farmers, nontaxable legal persons, and taxable legal persons who supply goods or services for which the VAT is not deductible, the thresholds discussed above act as a limitation on this practice in order to curb possible market distortion.<sup>66</sup> Large purchases exceeding the intra-Community acquisition thresholds will cause these entities to be subject to VAT obligations just like regular taxpayers.<sup>67</sup>

Two additional categories of transactions are worth noting. First, there are a number of transactions subject to VAT that qualify for special rules derogating from the general scheme for the duration of the transitional period. The Commission plans to abolish these derogations sometime in the future.<sup>68</sup> Second,

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64. *Id.* art. 28a(1)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 6. "New means of transport" is defined in *id.* art. 28a(2), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 6. As new means of transport is a specialized area, its proper treatment is beyond the scope of this article. Traders should consult their own domestic legislation.

65. Exemption without a right to deduction is to be contrasted with the practice known as "zero-rating," in which the supply is taxed at the rate of zero percent, and the theoretical deduction is granted on the tax form. Under zero-rating, unlike exemption, the administrative documents must be filled out, the VAT is paid on acquisition, charged on sales, and deducted in the normal way. According to the European Court of Justice in Case 268/83, *Rompelman v. Minister van Financiën*, [1985] E.C.R. 660, 664, "[f]rom the provisions [of Article 17 regarding scope of deductions and obligations] . . . it may be concluded that the deduction system is meant to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities. The common system of value-added tax therefore ensures that all economic activities, whatever their purpose or results, provided that they are themselves subject to VAT, are taxed in a wholly neutral way." *Id.*

66. See *supra* notes 56 & 61 and accompanying text for discussion on applicable thresholds.

67. Sixth VAT Directive, *supra* note 1, art. 28(1a)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 5, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 51.

68. These regimes are discussed in relevant sections of this article insofar as the general regime discussed below is modified to accommodate these derogations. See, e.g., *EC Commission Answers Question Regarding VAT on Telephone Services*, TAX NOTES INT'L, Dec. 21, 1992, available in LEXIS, Taxana Library, TNI File (noting Commissioner Scrivener's statement that "[t]he commission will shortly have to state its position on this matter in its proposal for a council directive on the abolition of certain derogations provided for in Article 28(3) of [Council Directive] 77/388 and in the second subparagraph of Article 1(1) of [Council Directive] 89/465 (successor to the Eighteenth VAT Directive)."

there are transactions subject to specialized procedures in order to simplify tax collection and prevent fraud. These include sales of means of transport,<sup>69</sup> supply of transport and services ancillary to transport,<sup>70</sup> goods subject to excise,<sup>71</sup> distance sales,<sup>72</sup> and "triangular operations" in which goods are sold to a trader in another Member State but are shipped from a third Member State.<sup>73</sup> These special procedures are likely to be retained in the final system if necessary. This article will discuss special procedures at relevant points only to the extent that they modify the general obligations.

## B. Obligations Under the General VAT Scheme

### 1. Registration for the VAT

All taxable persons are under a duty to notify tax authorities when their "activity as a taxable person commences, changes or ceases."<sup>74</sup> The definition of taxable person is any person who independently carries out economic activity in any place regardless of the proposed results of that activity.<sup>75</sup> Economic activity comprises all activities of producers, traders and persons supplying serv-

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69. For sales of private vehicles, taxation takes place at destination in all cases and the seller is always a taxable person for purposes of the transaction regardless of his volume of business. Such a rule is necessary to prevent distortions of trade resulting from people buying cars in the cheapest market. In practice, destination or consumption means the place of registration. The rule does not apply to dealer's stock in trade. Sixth VAT Directive, *supra* note 1, arts. 28a(4), 28c(A)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 6, 9.

70. See *supra* notes 49-51.

71. Goods subject to excise are subject to the VAT. Sixth VAT Directive, *supra* note 1, art. 28a(1)(C), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 5, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 50. Traders in these goods receive an exemption with a right to deduction. The general arrangements for excisable goods are set out in Council Directive 92/12 of 25 February 1992, 1992 O.J. (L 76) 1, as amended by Council Directive 92/108, 1992 O.J. (L 390) 124. These provisions provide for excisable goods to move throughout the Community under bond with "Appropriate Accompanying Documentation" (AAD). The VAT and excise duty only become payable in the Member State of final consumption when they are cleared from bond by a "Registered Excise Dealer and Shipper" (REDS). These special provisions are not covered in this article. Traders should consult the Council directives on the general arrangements, as well as directives on particular products, Council regulations, and domestic legislation.

72. Distance sales, in which the goods are transported by or on behalf of the supplier, are generally taxed in the place where the transport starts. The supply will be taxed where the transport ends if: the goods are transported by or on behalf of the supplier from a Member State other than that of arrival, and the purchaser is either a flat-rate scheme farmer who opted for the special scheme, a taxable person who carried out supplies for which VAT is not deductible and not subject to VAT obligations, a nontaxable legal person who is not subject to VAT, or a nontaxable person. The supply will be taxed in the State of origin, in any event, if: the goods are other than those subject to excise, new means of transport, or supplied after assembly or installation by or on behalf of the supplier, the total annual value of such supplies dispatched to the particular Member State in the current year does not exceed 100,000 ECU and did not exceed that threshold in the previous year. Member States may lower the threshold to 35,000 ECU and the value of supplies are tested against this threshold excluding VAT. Sixth VAT Directive, *supra* note 1, art. 28b(B), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 8. See *infra* Appendix B for distance sales thresholds in Member States.

73. See *infra* note 88 and accompanying text for a discussion of triangular contracts.

74. Sixth VAT Directive, *supra* note 1, art. 22(1)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12.

75. *Id.* art. 4(1).

ices including agricultural and professional activities.<sup>76</sup> Those involved in the exploitation of tangible or intangible property for the purpose of obtaining income,<sup>77</sup> and anyone who occasionally supplies new means of transport<sup>78</sup> or supplies buildings or unimproved land is considered a taxable person for purposes of that transaction.<sup>79</sup> The definition excludes employees, by virtue of the requirement that only independent economic activity is subject to the VAT.<sup>80</sup> Public bodies, when engaged in their capacity as public authorities, are not considered taxable persons.<sup>81</sup> The definition of "taxable person" differs among Member States, especially in Belgium, Portugal, and the United Kingdom; traders should consult their domestic legislation.<sup>82</sup>

Traders subject to one of the special regimes for flat-rate scheme farmers, nontaxable legal persons, and taxable legal persons who supply goods or services for which VAT is not deductible are not subject to the notification requirement to the extent that a derogation applies to their activities.<sup>83</sup> When these traders engage in activities not covered by their derogation, such as making intra-Community acquisitions of new means of transport, acquisition of goods subject to excise duties, or acquisitions exceeding the derogation threshold, they must comply with the notification requirement.<sup>84</sup>

76. *Id.* art. 4(2).

77. *Id.*

78. *Id.* art. 28a(4), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 6.

79. *Id.* art. 4(3).

80. *Id.* art. 4(4).

81. *Id.* art. 4(5).

82. See COOPERS & LYBRAND, A GUIDE TO VAT IN THE EC 12 (1993).

83. Sixth VAT Directive, *supra* note 1, art. 22(1)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12. It should be noted that application of this requirement is subject to the intricacies of the term "intra-Community acquisitions." Because this term is manipulated to satisfy the internal needs of the VAT system, it is broadly interpreted and includes unanticipated transactions. Alternatively, it may exclude some transactions that one would reasonably expect to be included.

The results can be quite complex as to whether an intra-Community acquisition has taken place. An example involves transfers by an undertaking, in which a taxable person's transfer of goods within his own business to another Member State for the purposes of that same business is, under certain circumstances, considered an intra-Community acquisition. *Id.* art. 28a(5)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 7, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 51. This provision is necessary to bring such transfers within the scope of VAT-monitoring. The provision for transfers is also subject to a long list of exceptions, under which no intra-Community acquisition will be deemed to have taken place if the transfer is for: the purpose of distance sales; installation and assembly; goods supplied on board ships, aircraft, and trains; exempt supplies pursuant to *id.* art. 28c(A), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 9, and by Council Directive 92/111, *supra* note 1, art. 1(12), at 51, if made on behalf of another taxable person; contract work that satisfies the conditions set forth in *id.* art. 28a(5)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 7; temporary use of goods for the purpose of supplying services in another Member State; and temporary use of goods for a period not exceeding 24 months. *Id.* art. 28a(5), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 7, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 51.

84. *Id.* art. 2(4)-(6).

In summary, parties who do not qualify for any of the above derogations and those who carry out intra-Community acquisitions which fall outside their derogation must notify tax authorities of their activities.<sup>85</sup>

## 2. VAT Identification Number

Parties subject to VAT administrative obligations are required to obtain a VAT identification number. This number is to be used on all sales invoices, statistical reports, and listings of sales and purchases to facilitate the verification of a right to deduction by traders making intra-Community acquisitions. These numbers can be obtained from the trader's domestic tax authority.

Three groups of traders are required to obtain VAT identification numbers. The broadest group comprises every taxable person within the Community who supplies goods and services which give rise to the right of deduction.<sup>86</sup> This is subject to certain exceptions. No VAT number is required for persons who provide services to customers who will be liable to pay VAT under the reverse charge mechanism,<sup>87</sup> or for persons to whom the simplification measures for

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85. *Id.* art. 22(1)(a)&(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12.

86. *Id.* art. 22(1)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 53. Generally, a right of deduction accrues to a taxable person if the supplies on which VAT has been charged are used for purposes of an economic activity, as opposed to purposes of a consumer nature. The scope of "economic activity" is illustrated by Case 165/86, *Leesportefeuille (Intiem) C.V. v. Staatssecretaris van Financiën*, [1989] 2 C.M.L.R. 856 (1988), in which the Court of Justice of the European Communities (ECJ) held that an employer was entitled to a deduction for goods supplied to one of his employees where the employer and the employee agreed that the latter would pay for the goods, the employee used those goods solely for purposes of his employer's business, and the supplier provided the employer with a proper invoice charging VAT on the goods.

87. Sixth VAT Directive, *supra* note 1, art. 22(1)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 53; *see also id.* art. 22(1)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12, and by Council Directive 92/111, *supra* note 1, art. 1(19), at 53 (defining scope of reverse charge). Article 21(1)(b) requires Member States to apply a reverse charge mechanism to a supplier who is established *abroad* when he provides certain enumerated services and certain conditions are satisfied. When the reverse charge mechanism applies, the supplier does not need a VAT identification number because the purchaser will be solely liable for the VAT.

There are three general categories in which the mandatory reverse charge applies. The first category comprises supplies listed under Article 9(2)(e) when supplied to any person. Article 9(2)(e) lists: copyrights; patents; trademarks; advertising services; consultants; engineers; lawyers; accountants; data processing; banking, financial and insurance services, with the exception of the hire of safes; supply of staff; the hiring out of movable tangible property, with the exception of all forms of transport; and the service of agents who procure any of the above in the name of and for the account of the principal.

The second category comprises supplies listed under *id.* arts. 28b(C)-(E), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 8. This category applies only when the listed supplies are provided to a party that is identified for VAT purposes. *Id.* art. 22(1)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12, and by Council Directive 92/111, *supra* note 1, art. 1(19), at 53. The enumerated supply of services include the intra-Community transport of goods rendered to customers identified for VAT in a Member State other than that of the departure of the transport (services in the intra-Community transport of goods); and services involving activities ancillary to the intra-Community transport of goods, rendered to customers identified for

triangular contracts apply.<sup>88</sup> Member States also have the option of not requiring a VAT number for taxable persons who occasionally supply new means of transport, and those who occasionally supply new buildings and unimproved land.<sup>89</sup>

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VAT in a Member State other than that within the territory of which the services are physically performed (e.g., loading and handling).

The third category comprises services rendered by intermediaries acting in the name and for the account of other persons, provided that these services form part of the supply of services, the purpose of which is an activity ancillary to the intra-Community transport of goods and further provided that the customer is identified for VAT in a Member State other than that within the territory of which the ancillary service is physically performed (supply of services rendered by intermediaries). *Id.* arts. 28b(C)-(E), as amended by Council Directive 91/680, *supra* note 1, art. 1(22) at 8.

88. *Id.* art. 22(1)(c)(replaced by art. 28h), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 53; see also *id.* art. 22(1)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12, and by Council Directive 92/111, *supra* note 1, art. 1(9), at 53 (defining conditions under which the simplified regime for triangular contracts applies);

Article 21(1)(a), as amended by Council Directive 92/111, *supra* note 1, art. 1(19), at 53, provides a simplified regime for contracts between three parties in different Member States in which supplier (A) sells goods to middle-man (B) who in turn immediately resells it to customer (C), and shipment to the customer is made directly from the original supplier (A). Normally, B would be required to register in A's Member State for the eventual intra-Community supply to C's Member State, or to register in C's Member State for the intra-Community acquisition which is then followed by a supply in Member State C.

The simplification regime obviates the need for B to register in another Member State provided that C is designated as the person liable for the tax. B does not need another VAT identification number provided that B has a VAT identification number in his own Member State; B acquired these goods from supplier A in a Member State in which B is not identified for VAT; B does not have a VAT number in the Member State of arrival (C's Member State); the goods are directly dispatched from A's Member State to C's Member State; C is a taxable person or a nontaxable legal person who is registered for VAT and has a VAT identification number in his own Member State; C is designated by B to pay the tax, and proper invoice procedures are followed. *Id.* 28c(E)(3), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 10, and by Council Directive 92/111, *supra* note 1, art. 1(13), at 52.

In terms of tax liability, compliance with the above requirements and administrative obligations will result in no VAT charge on the supply from A to B (this transaction is actually exempted under Article 28a(5)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 7); and no VAT charge on the acquisition by B in the Member State of arrival (C's Member State). The subsequent supply of goods from B to C is deemed to take place in the Member State of arrival, and this final leg of the transaction will be subject to VAT but the charge will be shifted to the customer in the Member State of arrival (C). *Id.* art. 22(1)(a), as amended by Council Directive 92/111, *supra* note 1, art. 1(19), at 53.

If B fails to demonstrate that the goods were acquired for the purpose of a subsequent supply in the Member State of arrival (C's Member State), to designate C as the person liable for the tax, or to properly identify C on his recapitulative statement, tax liability will not shift to C and the goods will be deemed to have been acquired in B's Member State and B will be subject to tax. *Id.* art. 28b(A)(2), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 7, and by Council Directive 92/111, *supra* note 1, art. 1(11), at 51.

Member States are granted a derogation to tax suppliers that have appointed a tax representative in the Member State other than the one in which the supplier is registered. Member States may also hold parties other than C jointly and severally liable for the tax. *Id.* art. 22(1)(a), as amended by Council Directive 92/111, *supra* note 1, art. 1(19), at 53.

89. *Id.* art. 22(1)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 53; see also *id.* art. 4(3) (buildings and land); *id.* art. 28a(4), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 6 (occasional supply of new means of transport).

The second group of persons required to obtain a VAT identification number comprises parties who must register for VAT and declare intra-Community acquisitions,<sup>90</sup> and taxable parties who qualify for a special scheme but opt for the general VAT obligations.<sup>91</sup>

The third group includes every taxable person who, within the territory of a Member State, effects intra-Community acquisitions of goods for the purpose of his operations relating to economic activities carried out abroad.<sup>92</sup> This allows the trader to obtain intra-Community acquisitions exempt from the tax due in the seller's Member State.

### 3. Accounts and the VAT Register

The transitional regime obligates traders to adopt certain record keeping methods. The first of these obligations requires taxable persons to maintain accounts in sufficient detail for the application of VAT and inspection by authorities.<sup>93</sup> The second obligation requires the taxable person to maintain a register of the goods he has dispatched or transported. For certain transactions, he must also maintain a register of the goods which have been dispatched or transported on his behalf out of his Member State but within the Community.<sup>94</sup> These transactions involve situations in which an intra-Community acquisition actually took place or is deemed to have taken place. They include the supply of contract work performed in the Member State of arrival, services involving work on goods physically performed in the Member State of arrival of the goods, temporary use of goods within the Member State of arrival for the purposes of supply of services by the taxable person established within the Member State of departure of the goods, and temporary use of goods for a period not exceeding 24 months that would also be eligible for temporary importation with full exemption from import duties.<sup>95</sup>

In the case of contract work, a contractor must also keep a register of all materials dispatched to him from other Member States by or on behalf of his customer for the purpose of carrying out the contract work.<sup>96</sup>

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90. *Id.* art. 22(1)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14; see also *id.* art. 22(1)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22) at 12, and by Council Directive 92/111, *supra* note 1, art. 1(19), at 53, which defines the scope of declaration and registration for intra-Community acquisitions.

91. *Id.* art. 22(1)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14.

92. *Id.* art. 22(1)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 53.

93. *Id.* art. 22(2)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 12.

94. *Id.* art. 22(2)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13; see also *id.* art. 28a(5)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 7, and by Council Directive 92/111, *supra* note 1, art. 1(10) at 51.

95. *Id.* art. 28a(5)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 7, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 51.

96. *Id.* art. 22(2)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13.

#### 4. Invoices

The administration of the VAT system hinges upon the proper issuance of invoices. The system is said to be self-policing because the tax is paid upon sale and a deduction is subsequently granted if the purchaser can demonstrate his right to the deduction by providing an appropriate invoice. The seller is under a duty to provide an invoice, and the purchaser bears the burden of substantiating his right to a deduction. The specific provisions relating to invoices are reviewed below.

The basic provision mandates that every taxable person provide an invoice and retain a copy of that invoice for the sale of goods and services to all taxable persons and nontaxable legal persons;<sup>97</sup> for the sale of goods under the distance sale provisions where the place of supply is the Member State of arrival; and for intra-Community supplies that are exempt upon introduction into the reporting Member State with a right to deduction.<sup>98</sup> Exempt treatment for intra-Community supplies is applicable to goods and services referred to in Article 5, which include the right to dispose of tangible moveable property, immovable property where Member States so elect; electricity, gas, heat, and refrigeration; deliveries of contract work performed in a Member State other than where the customer is identified for VAT; supply of new means of transport; certain supplies of goods subject to excise duty;<sup>99</sup> and transfers of goods by a taxable person from his undertaking to another Member State when made on behalf of another taxable party.<sup>100</sup>

The requirement of an invoice where a customer makes a payment prior to the supply of goods and services has been expanded and bifurcated. First, as to goods described in the paragraph above, a seller must issue an invoice where payment is made prior to any supply of such goods.<sup>101</sup> The new provision deletes the language that previously limited the requirement of an invoice to situations where the payment was made by a taxable party. The new requirement now applies without regard to whether payment is being made by a taxable or nontaxable legal person or a registered or unregistered person. The requirement also applies regardless of where the place of supply is deemed to be. Second, as to any services, a seller must issue an invoice where payment is made by a taxable or nontaxable legal person prior to the completion of services.<sup>102</sup> This

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97. The requirement that invoices are made to nontaxable legal persons was added by Council Directive 91/680, *supra* note 1.

98. Sixth VAT Directive, *supra* note 1, art. 22(3)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 10.

99. *Id.* art. 28c(A)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 10, and by Council Directive 92/111, *supra* note 1, art. 1(12), at 51.

100. *Id.* art. 28c(A), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 9, and by Council Directive 92/111, *supra* note 1, art. 1(12), at 51. See *supra* notes 43-51 and accompanying text for a discussion of exempt supplies.

101. Sixth VAT Directive, *supra* note 1, art. 22(3)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13.

102. *Id.*

extends the invoice requirement to advance payments made by nontaxable legal persons.

As to the information to be provided on the invoice, all invoices must still state clearly the price, exclusive of tax, the relevant tax at each rate, and any exemptions.<sup>103</sup> The amendments significantly expand the information required in certain situations described below.

In the case of a supply of goods to another Member State which is exempt under Article 28c(A)(a),<sup>104</sup> the invoice must contain the VAT number of the taxable person who supplies the goods and the VAT number of the person acquiring the goods.<sup>105</sup>

In the case of transactions involving the supply of services in the intra-Community transport of goods, ancillary services to intra-Community transport of goods, or services rendered by intermediaries,<sup>106</sup> the invoice must also contain the taxable person's VAT number, the customer's VAT number, and the VAT number under which the customer received the services.<sup>107</sup>

In the case of new means of transport, the invoice must also list the particulars provided in Article 28a(2) necessary to identify the good.<sup>108</sup> These include such information as the mileage on a vehicle, number of hours on an aircraft or vessel, as well as its weight, length, and date of entry into service.<sup>109</sup>

In the case of triangular contracts where the simplification provisions of Article 28c(E)(3) apply,<sup>110</sup> the invoice must also include explicit reference to the type of transaction in the form of a code, a VAT identification number for the taxable person who has carried out the intra-Community acquisition and subsequent supply (this is the intermediary, or "B" in this context), and the VAT number for the person to whom this supply is made ("C").<sup>111</sup>

Member States are instructed to provide criteria to determine whether a document may be considered an invoice.<sup>112</sup> They are given discretion to specify additional requirements to those mandated under Community law to enable tax administrators to collect VAT, verify deductions, and combat fraud. They may not, however, impose invoice requirements that "by reason of their number or

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103. *Id.* art. 22(3)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13, and Council Directive 92/111, *supra* note 1, art. 1(20), at 53.

104. *Id.* art. 28c(A)(a), as amended by Council Directive, *supra* note 1, art. 1(22), at 9. See *supra* notes 41-51 and accompanying text for a discussion of exempt supplies.

105. *Id.* art. 22(3)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 53.

106. *Id.* art. 28b(C)-(E), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 8.

107. *Id.* art. 22(3)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 53.

108. *Id.*

109. *Id.* art. 28a(2), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 6.

110. Under these provisions, VAT is not charged to the intermediary, but directly to the ultimate purchaser. See *supra* note 88 (discussing the simplification provisions for triangular contracts).

111. Sixth VAT Directive, *supra* note 1, art. 22(3)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 53.

112. *Id.* art. 22(3)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13.

technical nature, render the exercise of the right to deduction practically impossible or excessively difficult."<sup>113</sup>

### 5. *Filing of Returns and Payment of Taxes*

The timing provisions for tax returns are not changed by the amendments which took effect on January 1, 1993. Member States retain their discretion to set tax periods of one month, two months, quarterly, or other duration so long as it does not exceed one year. The deadline for filing must be no later than two months after the end of the period.<sup>114</sup>

Changes as to the substantive information required on tax returns have been made. First, the Sixth Directive's original requirement of reporting the information necessary to calculate tax, deductions, basis of assessment, and value of exemptions survives with slightly different language to reflect the terminology of the amendments.<sup>115</sup> Second, a list of additional information is also now required.

After January 1, 1993, for goods and services effected within the reporting Member State, returns must also set out the total value of all exempt intra-Community supplies,<sup>116</sup> total value of all actual<sup>117</sup> and fictitious intra-Community acquisitions,<sup>118</sup> and total value of supplies provided under the simplification regime for triangular contracts.<sup>119</sup> The returns must also set out the total value of supplies provided under the distance sales regime, making separate entries for sales to another Member State where the goods are sent from the reporting Member State, and for sales to the reporting Member State where the goods are sent from another Member State.<sup>120</sup> In addition, the returns must set out the total value of goods installed or assembled by or on behalf of the supplier, making separate entries for supplies made in another Member State where the place of departure is the reporting Member State, and for supplies completed in the

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113. See *Joined Cases 123 & 330/87, Léa Jorion (née Jeunehomme) & Société Anonyme D'étude et de Gestion Immobilière (EGI) v. Belgian State*, [1988] E.C.R. 4517 (ruling that Community provisions relating to invoices are not exclusive and that Member States may require additional information as necessary to ensure the correct levy of VAT. They are, however, not to frustrate the right of parties to obtain their deductions.)

114. Sixth VAT Directive, *supra* note 1, art. 22(4)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13.

115. *Id.* art. 22(4)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13.

116. *Id.* arts. 22(4)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 53-54. See *supra* notes 41-52 and accompanying text for discussion of exempt supplies under article 28c(A).

117. Sixth VAT Directive, *supra* note 1, art. 22(4)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 53.

118. *Id.*; see also *supra* notes 39-41 and accompanying text for a discussion of "fictitious" intra-Community supplies.

119. Sixth VAT Directive, *supra* note 1, art. 22(4)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 53; see also *supra* note 88 for a discussion of triangular contracts.

120. Sixth VAT Directive, *supra* note 1, art. 22(4)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 53. See *supra* note 72 and accompanying text for a discussion of distance sales.

reporting Member State where the place of departure is another Member State.<sup>121</sup> The total value of supplies reported are to exclude the VAT charged.

Payment must be made with the tax return, unless the reporting Member State has set a different deadline or requires submission of an interim payment.<sup>122</sup> Terra and Kajus note that the amendments' substitution of "regular return" for "return" renders this provision inapplicable to situations where no regular return would exist, such as in the case of occasional sales of new means of transport.<sup>123</sup> In this particular example, the amended language better comports with Article 22(10) which requires Member States to adopt a separate filing and payment regime for new means of transport.<sup>124</sup>

### 6. Recapitulative Statement

Community traders are required to report all intra-Community sales within a set period in a summarized statement known as a "recapitulative statement," "European Community Sales List" or "ECSL." The recapitulative statement imposes a compulsory obligation on every taxable person identified by a VAT identification number. The statement reports the VAT registration number of each Community customer together with the value of intra-Community sales to that customer in the period covered. The statement provides information on acquirers of exempt intra-Community supplies;<sup>125</sup> constructive or fictitious exempt intra-Community supplies;<sup>126</sup> consignees of transactions involving supplies of contract work where the materials used are sent out of the customer's Member State to the contractor and the finished product is then returned to the customer's Member State,<sup>127</sup> and consignees of triangular contracts subject to the simplified rules.<sup>128</sup>

The recapitulative statement provides tax administrators with the necessary information to verify that deductions are properly taken by those acquiring goods for commercial purposes. The information contained on the recapitula-

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121. Sixth VAT Directive, *supra* note 1, art. 22(4)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 53. See *supra* note 39 for a discussion of contract work.

122. Sixth VAT Directive, *supra* note 1, art. 22(5), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14.

123. TERRA & KAJUS, *supra* note 34, pt. II, ch. XIII, at 36.

124. Sixth VAT Directive, *supra* note 1, art. 22(10), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 15.

125. *Id.* art. 22(5)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 54. See *supra* notes 41-52 and accompanying text for discussion of exempt supply.

126. Sixth VAT Directive, *supra* note 1, art. 22(6)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14 and by Council Directive 92/111, *supra* note 1, art. 1(20), at 54. See *supra* notes 39-40 and accompanying text for a discussion of exempt supplies.

127. Sixth VAT Directive, *supra* note 1, art. 22(6)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14 and by Council Directive 92/111, *supra* note 1, art. 1(20), at 54; see also *supra* note 39 for discussion of contract work.

128. Sixth VAT Directive, *supra* note 1, art. 22(6)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14 and by Council Directive 92/111, *supra* note 1, art. 1(20), at 54. For discussion of triangular contracts, see *supra* note 88.

tive statement is fed into a computer network known as the VAT Information Exchange System (VIES). VIES is critical to the success of the self-reporting scheme. First, it gives traders the means to confirm their customers' VAT identification numbers with their national administration in order to substantiate that supplies are entitled to be taxed in the hands of the purchaser, not the seller. Second, VIES serves as the information exchange system used by law enforcement to combat tax fraud. For example, British authorities would use the information provided by other Member States through VIES to verify that their own citizens are properly paying VAT on intra-Community acquisitions they receive from traders in other Member States. Tax authorities verify the deductions for intra-Community acquisitions reported on a taxable person's return by matching them with the total volume of intra-Community supplies attributed to his VAT number as reported on the recapitulative statements of his suppliers. Commission Regulations provide rules regarding the storage of data and procedures for Member States to exchange information and cooperate on enforcement.<sup>129</sup>

The Member States have great discretion over the procedures used in gathering the information as well as in setting reporting periods. The Community has sought to balance the need for up-to-date information with the burden that reporting places upon traders. Member States are encouraged to consolidate collection of tax and reporting obligations in order to reduce administrative costs to traders.

As a general rule, Community legislation suggests a quarterly system for filing recapitulative statements.<sup>130</sup> In derogation from this general rule, Member States can choose to require monthly statements from all or certain categories of taxpayers.<sup>131</sup> Member States that elect to require monthly statements typically require them from only their largest companies.<sup>132</sup>

In addition, Community legislation gives the Council authority to grant Member State's requests to simplify the quarterly statement obligations.<sup>133</sup> It specifies two forms that these derogations may take. The requirements are such that only small and medium sized businesses are eligible for the derogations, and neither derogation is available to businesses that supply new means of transport.<sup>134</sup>

Article 22(12)(a) authorizes the first form which allows taxpayers to file a one-year recapitulative statement provided that the total annual value, less VAT,

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129. See Commission Regulation 218/92 of 27 January 1992, 1992 O.J. (L 24) 1.

130. Sixth VAT Directive, *supra* note 1, art. 22(6)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 54.

131. *Id.* art. 22(6)(c) as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 18.

132. In the United Kingdom, for example, small businesses have successfully lobbied the government to raise these thresholds. The threshold for the monthly statement in the United Kingdom is £135,000 of annual sales or purchases of supplies. Martin Lynchehan, *VAT on EC Exports & Imports: The New Rules*, THE IN-HOUSE LAWYER, Dec. 1992-Jan. 1993, at 12.

133. Sixth VAT Directive, *supra* note 1, art. 22(12), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 15.

134. Sixth VAT Directive, *supra* note 1, art. 22(12)(a), as amended by Council Directive 91/680, *supra* note, art. 1(22), at 15.

of their supplies of goods or services as defined in Articles 5, 6, and 28a(5) does not exceed by more than 35,000 ECU the annual turnover used as a reference for exemption under Article 24. In addition, the total annual value of exempt supplies effected under Article 28c(A) must not exceed 15,000 ECU, and cannot include new means of transport.<sup>135</sup> Denmark,<sup>136</sup> Ireland,<sup>137</sup> Italy,<sup>138</sup> Luxembourg,<sup>139</sup> the Netherlands,<sup>140</sup> and Spain<sup>141</sup> have obtained authorization by the Council to adopt one-year recapitulative statements for such enterprises.

The second form of derogation is available to small-volume taxpayers who are permitted by their Member State to file a tax return covering a period of greater than three months.<sup>142</sup> Where Member States require tax returns for a period longer than three months, they may authorize recapitulative statements to cover that same period.<sup>143</sup> This permits qualified taxpayers to file their recapitulative statement when they file their returns. Since Article 22(4) sets a one-year collection limit for Member States, this second form of derogation effectively has a one-year reporting limit.<sup>144</sup> This treatment is available to persons subject to a longer tax return period, provided that the total annual value of goods or services as defined in Articles 5, 6, and 28a(5), including contract work which they supply, does not exceed 200,000 ECU. Moreover, the total value of exempt supplies effected under Article 28c(A) cannot exceed 15,000 ECU and those exempt supplies cannot include new means of transport.<sup>145</sup> Denmark,<sup>146</sup> Germany,<sup>147</sup> Ireland,<sup>148</sup> Luxembourg,<sup>149</sup> the Netherlands,<sup>150</sup> and the United Kingdom<sup>151</sup> have obtained authorization to extend this treatment to their traders.

Generally, the only restriction regarding the frequency of sales list reporting is that Member States are prohibited from requiring recapitulative statements more than once a month.<sup>152</sup> Presumably, however, there is room for additional

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135. *Id.* This provision, which modifies the recapitulative statement obligation for certain smaller enterprises, is distinct from the special regime for small undertakings which qualify under Article 24. The Article 24 thresholds are discussed *supra* note 56 and accompanying text.

136. Council Decision 92/615 of 21 December 1992, 1992 O.J. (L 408) 11.

137. Council Decision 92/617 of 21 December 1992, 1992 O.J. (L 408) 13.

138. Council Decision 92/618 of 21 December 1992, 1992 O.J. (L 408) 14.

139. Council Decision 92/619 of 21 December 1992, 1992 O.J. (L 408) 15.

140. Council Decision 92/620 of 21 December 1992, 1992 O.J. (L 408) 16.

141. Council Decision 92/616 of 21 December 1992, 1992 O.J. (L 408) 12.

142. Sixth VAT Directive, *supra* note 1, art. 22(4), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 53.

143. See *supra* note 114 and accompanying text for discussion on filing periods for tax returns.

144. Sixth VAT Directive, *supra* note 1, art. 22(4), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 13, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 53.

145. *Id.* art. 22(12)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 16.

146. Council Decision 92/615, *supra* note 136.

147. Council Decision 92/614 of 21 December 1992, 1992 O.J. (L 408) 10.

148. Council Decision 92/617, *supra* note 137.

149. Council Decision 92/619, *supra* note 139.

150. Council Decision 92/620, *supra* note 140.

151. Council Decision 92/621 of 21 December 1992, 1992 O.J. (L 408) 17.

152. This is implicit in the derogations, which are exclusive. See Sixth VAT Directive, *supra* note 1, art. 22(6)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14.

reporting requirements where fraud is suspected, as the Directive provides a separate basis for requiring reports that is not restricted to a monthly limit.<sup>153</sup>

The specific information required by Community legislation depends upon the type of transaction listed. The minimum requirements provided under Community law are described below. Member States may require additional information on the recapitulative statement for the purpose of combatting tax fraud.<sup>154</sup> Community traders should consult their domestic tax administration for these details.

*a. Exempt Intra-Community Supplies*

For exempt intra-Community supplies, the supplier must list his VAT number in the reporting Member State under which he provided the supplies.<sup>155</sup> In addition, he must list the VAT number under which the customer in the other Member State received the goods, as well as the total value of intra-Community supplies per customer.<sup>156</sup>

*b. Supply of Goods to Contractor Who Will Conduct Contract Work on the Goods in the Member State Where the Goods Arrive*

In some cases, goods are dispatched by the taxable person or on his behalf in order to provide supplies to a contractor whom the taxable person has retained to conduct contract work as defined in Article 28a(5)(a). Both the goods supplied and the labor performed are considered a supply that must be listed. This section deals with the listing requirements for the goods supplied; the supply of labor is considered in the next section.

In order to list the goods supplied, the taxable person who is dispatching the goods should indicate the following items on his recapitulative statement for the period during which the goods were dispatched: (i) the VAT number in the Member State of dispatch of the taxable person dispatching the goods; (ii) the VAT number in the Member State of arrival of the taxable person to whom the goods have been dispatched in order to perform contract work upon them; and (iii) a statement in the form of a code indicating that the goods have been transferred under the conditions above for the purpose of contract work physically carried out in the Member State of arrival.<sup>157</sup> There is no requirement to state the value of the goods transferred.

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153. *Id.* art. 22(8), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 15.

154. *Id.* art. 22(6)(c), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14.

155. *Id.* art. 22(6)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14, and by Council Directive 92/111, art. 1(20), *supra* note 1, at 54.

156. *Id.* See *supra* notes 41-52 and accompanying text for discussion of exempt supplies.

157. Sixth VAT Directive, *supra* note 1, art. 22(6)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14, and by Council Directive 92/111, art. 1(20), *supra* note 1, at 54.

c. *Contract Work as an Exempt Intra-Community Supply of Services*

When a taxable party (a contractor) contracts with a customer to perform work on goods which are provided to the contractor by the customer or by some third party on behalf of the customer, the contractor is providing a supply of services.<sup>158</sup> This should be reported as an exempt intra-Community supply. Note that the supply of services is distinct from the goods the services are performed upon. In reporting supply of services, the contractor should include the VAT number of the contractor in the reporting Member State in which he is performing the services, the VAT number of the customer, the total value of the services provided (the value of goods on which the contractor performs is not included), and a statement in the form of a code indicating that the transaction is an intra-Community supply of contract work qualifying as an exempt intra-Community supply of goods.<sup>159</sup>

d. *Transfers of Goods by an Undertaking (Self-Supplies)*

Where a trader transfers goods that he owns from one Member State to another within the same legal entity, the trader should include on his recapitulative statement the undertaking's VAT number in the reporting Member State (country of dispatch), the undertaking's VAT number in the Member State of receipt of the goods, and the total value of the goods transferred.<sup>160</sup>

e. *Triangular Contracts*

Where a taxable party applies the simplification measures for triangular contracts in which he acquires goods and makes a subsequent supply by having them shipped to the customer from his own supplier,<sup>161</sup> the taxable party must provide the VAT number in the reporting Member State under which he carried out acquisition and subsequent supply of goods. In addition, the taxable party must provide the customer's VAT number in the country of arrival of the subsequent supply, and for each customer, the value of the supplies made by the taxable person in the Member State of arrival to that customer.<sup>162</sup>

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158. *Id.* art. 28a(5)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 7, specifies that the supply of contract work is to be considered a supply of goods, as opposed to its more natural classification as a service for purposes of Article 22(6)(b). Thus, Article 22(6)(b), which speaks only in terms of "goods," includes contract work as a supply of goods.

159. *Id.* art. 22(6)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14, and by Council Directive 92/111, art. 1(20), *supra* note 1, at 54. See *supra* note 39 for discussion of contract work.

160. Sixth VAT Directive, *supra* note 1, art. 22(6)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14, and by Council Directive 92/111, art. 1(20), *supra* note 1, at 54. See *supra* note 40 for discussion of self-supplies.

161. The taxable party refers to "B," the middleman in the triangular contract who carries out the initial acquisition of goods from A and subsequent supply of goods to the customer ("C"; note that "customer" as used here does not necessarily mean final consumer). See *supra* note 88 for discussion of triangular contracts.

162. Sixth VAT Directive, *supra* note 1, art. 22(6)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14, and by Council Directive 92/111, art. 1(20), *supra* note 1, at 54.

*f. New Means of Transport and Goods Subject to Excise*

The reporting requirements for sales of new means of transport and goods subject to excise are not prescribed by Community legislation and are left to the Member States.<sup>163</sup> Traders should consult their domestic legislation.

*g. Miscellaneous Provisions*

Any price adjustments in the case of cancellation, refusal, total non-payment, or price reduction after the supply takes place results in a reduction in the taxable amount according to the rules set forth by Member States. These adjustments should be set out in the recapitulative statement covering the period during which the person acquiring the goods is notified of the adjustment.<sup>164</sup>

Parties who are jointly and severally liable for payment of the VAT as a result of conducting taxable transactions as residents abroad or parties who are considered to be liable for payment of the tax when they acquire certain intangible supplies from suppliers abroad under the reverse charge mechanism will also be required to comply with the reporting requirements.<sup>165</sup> These parties should consult their domestic legislation.

In addition to the compulsory recapitulative statement, Community legislation grants Member States the option of requiring quarterly or monthly recapitulative statements from those who effect intra-Community acquisitions.<sup>166</sup> Italy and Spain have exercised this option.<sup>167</sup> Community legislation also grants Member States discretion to impose any other obligations on intra-Community traders necessary to combat tax evasion, provided that these obligations do not give rise to formalities at internal borders or unequal treatment of traders.<sup>168</sup>

Community legislation also permits Member States to release certain parties from all or part of their VAT registration, identification, declaration, and payment responsibilities. Member States may release the following parties from all obligations: (i) taxable persons supplying goods or services in the public interest that are exempt under Article 13, such as children's clothes, telecommunications services, health and welfare services, and religious and philanthropic activities;<sup>169</sup> (ii) taxable persons supplying goods or services under Article 15 such as goods exported from the Community, services performed on moveable tangible property within the Community for the purpose of exporting the prop-

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163. *Id.* art. 22(6)(d)&(11), as amended by Council Directive 91/680, *supra* note, art. 1(22), at 15, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 54.

164. *Id.* art. 22(6)(b), as amended by Council Directive 91/680, *supra* note, art. 1(22), at 15, and by Council Directive 92/111, *supra* note 1, art. 1(20), at 54.

165. *Id.* art. 22(7), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 15.

166. *Id.* art. 22(6)(e), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14.

167. As of March 1993, Spain and Italy had exercised this option. See COOPERS & LYBRAND, *supra* note 82, at 52.

168. Sixth VAT Directive, *supra* note 1, art. 22(8), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 15.

169. *Id.* art. 22(9)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 15; see *id.* art. 13.

erty from the Community, supplies of goods for fueling and provisioning of vessels, aircraft, and diplomatic missions, and the services of brokers and other intermediaries (excluding travel agents) acting outside of the Community or involved in any of the above transactions;<sup>170</sup> (iii) taxable persons who are eligible for the exemption for small undertakings in Article 24; (iv) flat-rate scheme farmers;<sup>171</sup> and (v) taxable persons carrying out none of the transactions which are required for inclusion in the tax return.<sup>172</sup>

### 7. *Optional Annual Statement*

Member States can opt to require a supplemental annual statement covering all transactions carried out during the preceding year. This statement is often referred to as a "yearly statement" or "annual recapitulative statement."<sup>173</sup> Where such a statement is used, Member States are required to request details on all transactions which would be reported on the tax return.<sup>174</sup> A number of States require these statements.<sup>175</sup>

### 8. *Trade Statistics: Intrastat Obligations*

In order to facilitate the removal of borders between Member States, traders are now required to provide trade statistics under a system known as Intrastat. Information formerly collected by customs officials from freight agents at the border is now submitted by individual businesses to authorities in their Member States.<sup>176</sup> The information collected is used to compile balance of trade statistics, aid in the analysis of competition rules, and provide information for the

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170. *Id.* art. 22(9)(a), as amended by Council Directives 91/680, *supra* note 1, art. 1(22), at 15; *see id.* art. 13, as amended by Council Directives 91/680, *supra* note 1 art. 1(12)-(19), at 4-5, and by Council Directive 92/111, *supra* note 1, art. 1(9), at 50.

171. *Id.* art. 22(9)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 15. This category of taxpayer is not permitted to take a deduction under the circumstances set out, and therefore no responsibilities for VAT are necessary. *See id.* art. 28a(1)(a) & (1a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22) at 5, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 50-51, which directs attention to Articles 15(4)-(10) and 25 of the Sixth VAT Directive.

172. *Id.* art. 22(9)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 15. *See supra* notes 115-121 for a discussion of the transactions required to be reported on tax returns.

173. Sixth VAT Directive, *supra* note 1, art. 22(6)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14. Article 22(6)(a) does not use the term "recapitulative statement" for the annual statement, but reserves this term for the mandatory periodic listings of Article 22(6)(b), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 18, and by Council Directive 92/111, *supra* note 1, art. 1(10), at 54. In order to reduce confusion and remain consistent with the legislation, the term "recapitulative statement" is not used here to refer to the annual statement.

174. *Id.* art. 22(6)(a), as amended by Council Directive 91/680, *supra* note 1, art. 1(22), at 14. *See supra* notes 115-121 for discussion of the information required by the tax return.

175. These countries are Belgium, Ireland, Portugal and Spain. COOPERS & LYBRAND, *supra* note 82, at 49.

176. *See* Council Regulation 3330/91 of 7 November 1991, 1991 O.J. (L 316) 1.

management and guidance of industry.<sup>177</sup> Most Member States have created new agencies to administer the system.<sup>178</sup>

Member States have certain discretion to merge or align the trade statistics obligations with their domestic collection requirements and are encouraged to do so in order to reduce the burden on business. The scheme is designed so that only the largest firms, representing approximately 20% of Community businesses and accounting for about 90% of intra-Community trade, are obligated to file Intrastat forms on a monthly basis.<sup>179</sup> A committee (hereinafter Committee) has been set up to advise on measures to meet this goal.<sup>180</sup> The Member States, with Commission approval, set thresholds above which larger Community companies are required to file monthly statements. For instance, the United Kingdom threshold for a monthly Intrastat statement is 186,000 ECU of Intra-Community purchases or sales, and the German threshold is 99,000 ECU.<sup>181</sup> Businesses with intra-Community acquisitions or sales above these thresholds must file a monthly Intrastat form.

The remaining firms are permitted either to file Intrastat forms less frequently, file less detailed forms, or be excused altogether.<sup>182</sup> To this end, Member States are required to set three additional thresholds, with Commission approval. The lowest level is a total exclusion from trade statistics obligations which automatically applies to small undertakings, flat-rate farmers, and institutional parties who are not liable to account for VAT.<sup>183</sup> The Regulation allows Member States discretion to broaden this exclusion with Commission approval.

Member states must also adopt simplification and assimilation thresholds. These thresholds are also subject to approval by the Commission in order to guarantee that information goals are reached.<sup>184</sup> They may vary from one Member State to another, by product group, or by reporting period.<sup>185</sup>

Firms qualifying under the simplification threshold are permitted to provide information in more summary form. For instance, qualifying firms are typically not required to provide a description of the items traded. For all Member States, simplification thresholds are automatically set at 100,000 ECU for intra-Community trade operations involving both dispatch and arrival.<sup>186</sup>

Firms qualifying under the assimilation threshold are permitted to include the Intrastat information in their periodic tax declarations and can, therefore,

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177. *Id.* (preamble).

178. For a list of those agencies, see B.J.M. Terra, *Removal of Fiscal Frontiers: VAT, Registration, Statistics and All That Jazz*, INT'L VAT MONITOR, Feb. 1993, at 2.

179. Opinion of the Economic and Social Committee on the Statistics Relating to the Trading of Goods Between Member States, § 4.8, 1990 O.J. (C 332) 1.

180. Council Regulation 3330/91, *supra* note 176, art. 30, at 9.

181. Terra, *supra* note 178, at 2.

182. Council Regulation 3330/91, *supra* note 176, art. 28, at 8.

183. *Id.* art. 28(3).

184. *Id.* art. 28(7).

185. *Id.* art. 28(6).

186. *Id.* art. 28(8).

dispense with filing a separate Intrastat.<sup>187</sup> Additionally, Member States may vary the frequency of reporting on a quarterly, half-yearly, or annual basis in order to align the statistic reporting with the collection of taxes or other reporting requirements.<sup>188</sup>

The Commission has enacted two regulations that implement the original regulation that established Intrastat.<sup>189</sup> Council Regulation 3046/92 of October 22, 1992 provides the basic informational requirements and the deadlines for submission.<sup>190</sup> Council Regulation 3590/92 of December 11, 1992 supplies the standardized forms that are used Community-wide for the Intrastat system.<sup>191</sup> The forms range in detail, depending upon whether the trader is subject to a special threshold.<sup>192</sup> As mentioned previously, the regulations allow elimination of the standardized forms when Member States merge Intrastat reporting with other VAT obligations.<sup>193</sup> Member States that assimilate their Intrastat obligations must adopt media that conform to Community regulation.<sup>194</sup>

The Commission has additional authority to further simplify data collection procedures.<sup>195</sup> The introduction of standardized Intrastat forms and Member State discretion to align the frequency of reporting to coincide with other tax reporting requirements exemplify application of this authority.

### 9. Practical Preparations

The following list represents the basic preparations companies should have engaged in before January 1, 1993 to comply with the new VAT regime:

- a. Sellers must have obtained VAT registration numbers from their nondomestic Community purchasers. Careful consideration should have been given to whether their customers are or should be VAT registered.
- b. VAT registration numbers should have been included on invoices.
- c. Country prefixes, for instance "GB" for Great Britain, should have been added at the beginning of the seller's VAT registration number.
- d. Companies should have omitted "outside-the-scope" supplies from all VAT returns where applicable.<sup>196</sup> These supplies need not be included in the recapitulative statement.

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187. Assimilation thresholds must be set higher than exclusion thresholds. *Id.* art. 28(4).

188. *Id.* art. 20, as implemented and amended by Council Regulation 3046/92 of 22 October 1992, 1992 O.J. (L 307) 27.

189. The Commission has also promulgated Council Regulation 854/93 of 5 April 1993 on Transit Statistics and Storage Statistics Relating to the Trading of Goods Between Member States, 1993 O.J. (L 90) 1.

190. See Council Regulation 3046/92, *supra* note 188.

191. Council Regulation 3590/92 of 11 December 1992, 1992 O.J. (L 364) 32.

192. *Id.* art. 2.

193. This assimilation is authorized under Council Regulation 3330/91, *supra* note 176, art. 28(4), at 8. Additional requirements are set out in Council Regulation 3590/92, *supra* note 191, art. 1(2), at 32.

194. Council Regulation 3590/92, *supra* note 191, art. 1(2), at 32.

195. Council Regulation 3330/91, *supra* note 176, art. 34(1), at 10.

196. Outside-the-scope supply is distinct from ancillary services. A typical example of ancillary services are loading and unloading of goods. In Case 163/91, *Beheersmaatschappij Van Ginkel*

- e. Companies should have charged non-VAT registered Community clients VAT at the standard rate and accounted for all such supplies provided.<sup>197</sup>
- f. Companies should have adopted accounting procedures to maintain separate VAT accounts and a register of all intra-Community sales and supply.<sup>198</sup>

### C. *Transitional Problems and Analysis of the New Obligations*

The introduction of the transitional regime requires businesses to comply with new obligations, and raises questions of how these obligations will burden traders and Member States. Such considerations will be relevant in evaluating both the success of the new regime as well as whether a further round of VAT changes should take place in 1997.

Upon introduction of the new regime, the European Commission urged tax authorities in the Member States to allow a grace period before imposing fines for late payments of VAT to provide traders an opportunity to familiarize themselves with the new obligations. This came largely in response to an Arthur Anderson & Co. study which reported that out of 150 large companies surveyed, 38% had collected less than half of the VAT numbers they needed and that 40% had supplied their VAT number to less than half of the companies that required them.<sup>199</sup> Some 35% of the companies had made no preparations. The study also noted that 88% of British companies were having problems making the changes, while only companies in the Netherlands thoroughly understood the changes required.<sup>200</sup>

The French Ministry of Finance authorized its traders to exempt from VAT the supply of goods and services in intra-Community transactions to purchasers who have not yet received their VAT registration number in accordance with the

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*Waddinxveen B.V. & Reizen Passagebureau Van Ginkel B.V. v. Inspecteur der Omzetbelasting*, Judgement of 12 November 1992, 1992 O.J. (C 319), a Dutch tour operator, who offered driving holidays in which the customer used his own car and the agent simply provided lodgings owned by third parties, charged VAT only on the portion of payment for rentals. *Id.* The Dutch tax collector rejected this calculation under the theory that these services provided by the operator qualified for VAT as leasing. *Id.* The ECJ ruled in favor of the tax administration on the theory that Article 26 of the Sixth Directive is to be interpreted as meaning that services provided in connection with the sale of a holiday are not to be excluded from the scope of ancillary services merely because the tour operator did not arrange for transport. *Id.*

197. The list of recommended procedures was adapted in part from the suggestions of the British Law Society. See *Single Market-VAT treatment of Supplies by Solicitors to Clients in EC Countries*, SIMON'S TAX INTELLIGENCE, NOTES & NEWS, Dec. 17, 1992, at 1080-81 [hereinafter *Single Market-VAT*].

198. For instance, in Britain, a new accounting standard called "FRS 3" has been adopted for all companies for financial years ending on or after June 22, 1993. FRS 3 facilitates collection of VAT by separating out intra-Community acquisitions. See FOREIGN TAX LAW BI-WEEKLY BULLETIN, Feb. 3, 1993, at 18-19.

199. *European Commission Urges the 12 National VAT Authorities to be Flexible When Imposing Fines for Late VAT Payments*, TAX NOTES INT'L, Dec. 28, 1992, available in LEXIS, Taxana Library, TNI File.

200. *Id.*

new procedures.<sup>201</sup> Likewise, the British stated their willingness to forgive errors during the first year of the new regime's operation.<sup>202</sup>

There is concern that the new system may create administrative burdens that will outweigh the benefits of eliminating border formalities. Reporting requirements are now assumed by the individual trader and both the recapitulative statement and the Intrastat are necessary to support different aspects of the Single Market. While domestic reporting and collection requirements are encouraged to be merged and aligned, Member States may impose additional reporting requirements, subject to the limitation that the recapitulative statement may not be required for a period of less than a month.<sup>203</sup>

Businesses have been worried that these new reporting requirements will cause a barrage of extra paperwork.<sup>204</sup> Member States have responded to these concerns differently. The Spanish have vindicated the business community's fears. A large Spanish company with gross sales exceeding 1 million pesetas is required to file a monthly self-assessment return (quarterly self-assessment returns are required for the remaining cases), an annual return summarizing all transactions during the past year, a quarterly recapitulative statement, and, finally, a monthly Intrastat return.<sup>205</sup> In contrast, the German authorities merged their domestic quarterly self-reporting requirement, which includes information on all transactions including intra-Community trade, with the intra-Community recapitulative statement in order to avoid duplicative reporting obligations.<sup>206</sup>

Governments have been concerned that the deferral of VAT collection will cause revenue and debt financing problems for Member States and trade distortions with respect to non-Community traders. Member State's tax authorities may wish to speed the collection of taxes in order to avoid increased government borrowings. The British Treasury replaced its quarterly VAT payment system with a monthly system in January, 1993 for this purpose.<sup>207</sup> Also, countries in the European Free Trade Association have charged that the deferral policy disadvantages them because it does not apply to non-Community imports

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201. Communique of the French Ministry of Finance (Jan. 29, 1993).

202. *Single Market-VAT*, *supra* note 197.

203. Council Regulation 3330/91, *supra* note 176, art. 22(6)(e), at 7.

204. See *Germany Implements EC Transitional VAT Regime*, 5 TAX NOTES INT'L 967, 969 (1992). See also *EC VAT Reforms More Costly for 10 Percent of Companies, Survey Finds*, 7 Tax Notes Int'l 1471 (1993) (reporting that survey of Deloitte & Touche found that 10 percent of the 2,500 companies surveyed pay higher VAT than they did under the old regime. This is due, in part, to the fact that a quarter of the companies that pay VAT in Member States in which they are not registered do not register precisely because of the new system); *U.K. Companies Criticise VAT Changes*, 7 TAX NOTES INT'L 454 (1993) (reporting that Price Waterhouse survey found that 68 percent of all companies surveyed believed they were financially worse off due to the new administrative burdens).

205. *Spain's Implementing Legislation for Transitional VAT Regime Examined*, 6 TAX NOTES INT'L 1082, 1083 (1993).

206. *Germany Implements EC Transitional VAT Regime*, *supra* note 204, at 967, 969.

207. TAX LAW BI-WEEKLY BULLETIN, July, 1992, at 3-4.

and is therefore discriminatory.<sup>208</sup> Similar concerns have arisen among Member States that form the Benelux region.<sup>209</sup>

Despite these concerns and problems, it is clear that the system will provide genuine benefits. First, it does for the most part greatly reduce the amount of paperwork. The system allows trading parties to report VAT to their domestic tax administration through a more consolidated method of VAT reporting based upon domestic summary reporting requirements. According to one estimate, this will abolish approximately 60 million customs forms per year throughout the Community.<sup>210</sup> The overall savings to both governments and the private sector is estimated to amount to 5-7% of the value of intra-Community trade.<sup>211</sup>

Second, the elimination of charging VAT at the border has a number of positive economic consequences for traders. For instance, firms no longer need to provide bank guarantees to customs officials for VAT payments. In addition, this method of taxation effectively defers the payment of taxation which is expected to provide substantial economic benefits to Community companies.<sup>212</sup>

According to Sir Brian Unwin, Chairman of HM Custom and Excise, this new regime will translate into a bottom line savings of up to £135 million per year for the period from 1993 to 1996 for British companies. These figures are based on savings in excess of £175 million per year due to the elimination of border formalities, less the costs of reporting requirements at approximately £40 million per year. British companies are also expected to incur one-time costs of £100 million for the implementation of the transitional VAT regime.<sup>213</sup> These one-time costs will be for such expenses as amending invoices to include the new country codes that are required to precede each registered transaction, changing accounting systems to separate out Community from non-Community trade for the purposes of VAT reporting, and retraining personnel.

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208. *Single Market Tax Policies Hinder EFTA Countries' Competition*, 6 TAX NOTES INT'L 318, 318-19 (1993).

209. This problem arises from the fact that, within the context of the Benelux countries, imports across the Belgian-Luxembourg or Belgian-Dutch border are treated differently under Belgian law. In a written question to the Commission, one commissioner defended the incongruity on the grounds that Article 233 of the Treaty of Rome allows for regional union among the Benelux countries to be preserved, and that the Sixth VAT Directive allows Member States to lay down the procedures governing the declaration and payment of VAT with respect to imported goods. This commissioner also noted that the concept of importation with regard to VAT will eventually disappear with the completion of the large internal market and that this will put an end to the existing differential arrangement. Written Question 2203/91 of 27 January 1992, 1992 O.J. 35 (C 20) 28-29.

210. *Customs News*, TAX'N, Nov. 26, 1992, at 205; see also *Commentary*, EUROPEAN ACCESS 1993, No. 1, Feb. 1993, at 10 (in which Commissioner Scrivener used similar figures).

211. Cnossen & Shoup, *supra* note 3, at 59.

212. *Europe Grasps the VAT Nettle*, INT'L TAX REV., Mar. 1993, at 41-43.

213. *Customs News*, *supra* note 210, at 10.

V.

RATE STRUCTURES: OVERVIEW OF COUNCIL DIRECTIVE 92/77 OF  
OCTOBER 19, 1992

This Part focuses on the rate structure adopted January 1, 1993 and on derogations from this scheme. The Council agreed upon a standard minimum rate of 15% and gave Member States discretion to utilize one or two special reduced rates of at least 5% for certain eligible goods or services.<sup>214</sup> Also, Member States have agreed that special high VAT-rates charged on such items as luxury goods will be eliminated as of January 1, 1993.<sup>215</sup> The Council has also provided for a number of temporary derogations.

The details of the new rate structure are primarily contained in Council Directive 92/77 of October 19, 1992 which amends both Article 12 and Article 28 of the Sixth VAT Directive. Article 12 specifies rates and Article 28 provides transitional provisions. The amendments to Article 12 are considered first and those relating to Article 28 follow.

A. *Standard Rate*

This Directive sets a standard minimum rate of 15%, which is applicable during the transition period.<sup>216</sup> The Council, by the terms of the Directive, is required to reach unanimous agreement on the minimum standard rate applicable after December 31, 1996.<sup>217</sup>

B. *Derogations*

The Directive also allows Member States to retain VAT rates that fall below the standard 15% rate under certain circumstances. These retained rates are referred to as "derogations" and are understood to be temporary in nature. Thus, the Directive presumes that these derogations are to be abolished.<sup>218</sup> These derogations are considered below in the order contained in the Directive.

1. *Annex H*

The first derogation allows Member States to apply up to two reduced rates not lower than 5% to supplies of goods and services listed in Annex H of the

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214. Sixth VAT Directive, *supra* note 1, art. 12(3)(a), as amended by Council Directive 92/77, *supra* note 1, art. 1(1) at 1, and by Council Directive 92/111, *supra* note 1, art. 1(7) at 49.

215. EURECOM, Nov. 1992; see also E.C. BULLETIN, Oct. 1992, § 1.3.19, at 26. Portugal has been slow in lowering its highest rate, which is 30%. See *infra* Appendix C for rates in Member States.

216. Sixth VAT Directive, *supra* note 1, art. 12(3)(a), as amended by Council Directive 92/77, *supra* note 1, art. 1(1) at 7, and by Council Directive 92/111, *supra* note 1, art. 1(7) at 49.

217. *Id.*

218. Further approximation of rates can be achieved by abolishing the enumerated derogations one by one. This method has already been followed by the Eighteenth Council Directive 89/465, *supra* note 25, which reduced the number of derogations in Annex E to the Sixth VAT Directive, *supra* note 1 from 15 to 4, and the number in Annex F from 27 to 14.

Directive.<sup>219</sup> Annex H covers goods and services that are basic necessities or have cultural or social significance. The list includes such products as certain foodstuffs, water, pharmaceutical supplies, medical equipment, newspapers, books, housing provided as part of a social policy, movies, and cultural events. The Council is required to review the scope of the reduced rates every two years and may alter the list of goods and services contained in Annex H pursuant to a Commission proposal.<sup>220</sup> The Directive leaves open the possibility for more frequent review.

## 2. *Natural Gas and Electricity*

Member States are also allowed to apply a reduced rate to supplies of natural gas and electricity, provided that the Commission does not find a risk of distortion of competition. There are no minimum limits for these reduced rates.<sup>221</sup> In order to apply this derogation, Member States are required to inform the Commission of their intention. If no negative reply is forthcoming within three months, no risk of distortion of competition is deemed to exist. The Directive, however, leaves open the possibility that the Commission may find distortion at a later time.

## 3. *Unresolved Issues Under Article 12*

The Council Directive explicitly leaves resolution of rates concerning works of art, second-hand goods, antiques and collector's items,<sup>222</sup> agricultural outputs, and gold<sup>223</sup> for other Commission proposals.<sup>224</sup> On February 10, 1993, the Commission presented its work program for 1993-94, which prioritizes approval of the gold and secondhand goods proposals as "extremely important."<sup>225</sup>

The temporary provision on agriculture contained in Council Directive 92/77 is already the subject of controversy. The provision allows a two-year postponement of the application of the standard rate.<sup>226</sup> This has the effect of allowing Member States to retain rates on agriculture that fall below the new

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219. Sixth VAT Directive, *supra* note 1, art. 12(3)(a), as amended by Council Directive 92/77, *supra* note 1, art. 1(1) at 1, and by Council Directive 92/111, *supra* note 1, art. 1(7) at 49.

220. *Id.* art. 12(4), as amended by Council Directive 92/77, *supra* note 1, art. 1(3), at 2.

221. *Id.* art. 12(3)(b), as amended by Council Directive 92/77, *supra* note 1, art. 1(1) at 1.

222. The Council recently agreed upon a directive on second-hand goods that will enter into force on July 1, 1994. It provides that VAT is to be charged at the standard rate to the seller's margin, not on the full sales price; that trades between private individuals are VAT-free; and that lower rates should apply to imports into the community. The directive also defines second-hand cars to be six months old or to have 6000 kilometers. See *EC Finance Ministers Agree to VAT Directive on Second-Hand Goods*, 7 TAX NOTES INT'L 1618 (1993).

223. On October 28, 1992, the Commission submitted to the Council of Ministers a proposal for a VAT Directive supplementing the common system of value-added tax and amending Directive 77/388 with a special scheme for gold. See Commission Proposal COM(92)441 final. This proposal is currently pending before the Council.

224. Sixth VAT Directive, *supra* note 1, art. 12(3)(c)-(e), as amended by Council Directive 92/77, *supra* note 1, art. 1(1), at 1-2.

225. *The Commission's Work Program for 1993-94*, E.C. BULLETIN, Jan. 1993, at 17.

226. Sixth VAT Directive, *supra* note 1, art. 12(3)(d), as amended by Council Directive 92/77, *supra* note 1, art. 1(1) at 1-2.

minimum, but prevents the introduction of any lower rates unless they fall under Annex H. Germany has interpreted this to mean that if the Council fails to reach unanimous agreement, then the reduced rates must continue to apply, whereas the French have adopted the view that the standard minimum rate will become applicable automatically.<sup>227</sup> The provision requires the Council to reach unanimous agreement on the taxation of agricultural outputs by December 31, 1994.<sup>228</sup>

#### 4. Article 28 Derogations

The amendments to Article 28 create various additional derogations from the standard 15% minimum VAT rate. These derogations are intended to apply only during the transitional period,<sup>229</sup> and are to be reviewed by the Commission and Council before December 31, 1994.<sup>230</sup> They are considered below in the order presented by the Directive.

The first derogation provides a grandfather clause for rates lower than the 5% reduced rate of Article 12(3), provided that the rate was already in effect on January 1, 1991 and applies to a good or service listed in Annex H.<sup>231</sup> For example, this derogation permits Member States that applied a VAT rate of less than 5% on newspapers on January 1, 1991 to retain the rate.

According to its terms, this derogation applies only if the reduced rate is applied in accord with Community law and satisfies the conditions stated in the last indent of Article 17 of the Second Council Directive 67/228 of April 11, 1967.<sup>232</sup> The relevant portion of the Second Council Directive reads: "such measures may only be taken for clearly defined social reasons and for the benefit of the final consumer, and may not remain in force after the abolition of the imposition of tax on importation and the remission of tax on exportation in trade between Member States."<sup>233</sup> Since the transitional scheme abolishes the imposition of tax on importation by replacing the collection of tax at the border with a regime of tax collected within the Member State of destination, it is unclear whether the derogation could satisfy this test if challenged.

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227. B.J.M. Terra, *Removal of Fiscal Frontiers: The Approximation of VAT Rates*, INT'L VAT MONITOR, Jan. 1993, at 3 [hereinafter Terra, *Removal of Fiscal Frontiers: The Approximation of VAT Rates*].

228. Sixth VAT Directive, *supra* note 1, art. 12(3)(d), as amended by Council Directive 92/77, *supra* note 1, art. 1(1) at 2.

229. *Id.* art. 28(2) as amended by Council Directive 92/77, *supra* note 1, art. 1(4), at 2; see also *id.* art. 281, as amended by Council Directive 92/111, *supra* note 1, art. 1(22) at 17.

230. *Id.* art. 28(2)(g), as amended by Council Directive 92/77, *supra* note 1, art. 1(4), at 3.

231. *Id.* art. 28(2)(a), as amended by Council Directive 92/77, *supra* note 1, art. 1(4), at 2. The applicability of this Article's grandfather clause to only those supplies listed in Annex H of the Sixth VAT Directive is implied from Article 28(2)(b)'s provision of an alternative rule for goods and services not listed in Annex H. Article 28(2)(e) similarly provides for supplies "other than those specified in Annex H." The derogation listed in Article 28(2)(e) also contains special provisions applicable only to Ireland in the event that the derogation creates distortions of competition in energy products for heating and lighting.

232. *Id.* art. 28(2)(a), as amended by Council Directive 92/77, *supra* note 1, art. 1(4), at 2.

233. Second Council Directive 67/228, *supra* note 13.

The second derogation contained in Article 28(2)(b) of the Sixth VAT Directive provides a grandfather clause for goods and services not listed in Annex H, to which a reduced rate of below 5% is applied.<sup>234</sup> Member States may retain their original VAT rate, or may choose to apply either of the two reduced rates provided for in Article 12(3) to any items not listed in Annex H, provided that the Member State's rate was in effect on January 1, 1991 and in accord with Community law. This provision allows, for instance, a Member State to retain, during the transitional period, a rate between zero and 4.99% on products not listed in Annex H.

This derogation reclassifies previously acceptable rates as "derogations" or "transitional provisions," thereby creating a presumption and framework for their eventual removal. Beyond this, however, it appears to render Article 28(2)(e) nugatory,<sup>235</sup> and can be explained only as a concession to Member States that wish to maintain existing rate structures.

The third derogation provides a concession to Member States that were obligated to increase their standard rate by more than 2% under Article 12(3). They will be permitted to introduce a reduced rate lower than the minimum 5% rate for items listed under Annex H, as well as for restaurant services, children's clothing and footwear, and housing.<sup>236</sup> This provision applies only to Spain and Luxembourg and was apparently necessary to obtain their agreement to a standard minimum VAT rate.<sup>237</sup>

The fourth derogation provides a grandfather clause that allows Member States to continue to apply a "reduced rate" that was in effect on January 1, 1991 to restaurant services, children's clothing and footwear, and housing.<sup>238</sup> As discussed below, the use of the term "reduced rate" should render this derogation applicable only to those rates which are above 5%.<sup>239</sup> Note that with the exception of housing, none of these items are listed under Annex H. Also, this provision's derogation for housing is much broader than that contained in Annex H, which limits itself to "housing provided as part of a social policy."

The fifth derogation is a modified grandfather clause which provides for partial retention of reduced VAT rates that were in effect on January 1, 1991 for items not listed in Annex H. It allows the Member State to apply its original

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234. Sixth VAT Directive, *supra* note 1, art. 28(2)(b), as amended by Council Directive 92/77, *supra* note 1, art. 1(4), at 2.

235. Attempts at reinterpreting Article 28(2)(b) of the Sixth VAT Directive in light of Article 28(2)(e) appear unsupported by Article 28(2)(b)'s own language. Instead, it appears necessary to interpret Article 28(2)(e) in light of Article 28(2)(b), which is discussed *infra* note 241 and accompanying text.

236. Sixth VAT Directive, *supra* note 1, art. 28(2)(c), as amended by Council Directive 92/77, *supra* note 1, art. 1(4), at 2. This provision, by its terms, does not authorize Member States to introduce exemptions with a refund of the tax at the preceding stage (known as "zero-rating"). See *supra* note 65 for a discussion of zero-rating.

237. Terra, *Removal of Fiscal Frontiers: The Approximation of VAT Rates*, *supra* note 227, at 6.

238. Sixth VAT Directive, *supra* note 1, art. 28(2)(d), as amended by Council Directive 92/77, *supra* note 1, art. 1(4), at 2.

239. See *infra* note 241 and accompanying text.

reduced rate, or replace it with either of the two reduced rates provided in Article 12(3), so long as the rate to be applied under either option is at least 12%.<sup>240</sup> Unless the good or service comes under some other derogation, or the original rate is already 12%, Member States relying on this derogation must raise their rates to at least 12% for items not listed in Annex H.

As discussed above, the second derogation of Article 28(2)(e) appears to conflict with the fifth derogation of Article 28(2)(b), which similarly allows retention of reduced rates already in effect on January 1, 1991 for supplies not listed on Annex H, but without the additional 12% requirement. Professor B.J.M. Terra suggests that these two provisions can be reconciled by interpreting Article 28(2)(e) to apply only to those rates that, on January 1, 1991 were already above the 5% minimum reduced rate of Article 12(3) and in conformity with both Community law and Article 17 of the Second Directive.<sup>241</sup> This analysis apparently rests on an interpretation of the term "reduced rate" to mean a rate at or above the 5% minimum reduced rate referred to under Article 12(3). Only where the term explicitly appears as "reduced rate lower than the minimum laid down in Article 12(3)," as it does in Article 28(2)(b) and (c), would it retain rates falling below the Article 12(3) minimum.

While Article 28(2)(e) may appear to have little effect in light of Article 28(2)(b) at this time, its purpose may emerge once the process of abolishing the remaining derogations commences. These two articles may provide a mechanism to separate derogations in order to prioritize them for abolition. If this is their purpose, a number of considerations could affect their order of elimination. First, because Article 28(2)(b) derogations fall furthest outside the standard 15% rate, they should be first priority. Second, since those same derogations retain the very lowest rates which apply to socially sensitive supplies, they might escape abolition. Third, because Article 28(2)(e) derogations are already close to the standard rate, abolition of these derogations would not cause significant hardship to the final consumer. Fourth, since these same derogations are so close to the standard rate, they are unlikely to distort competition. Finally, fiscal and economic considerations are likely to play a central role in the outcome of this debate.<sup>242</sup>

Another possible significance of the Article 28(2)(e) derogation is that it temporarily provides the option of a third reduced rate between 12 and 15%. This would expand the two-rate VAT system as provided by Article 12(3) to a three-rate VAT. In light of the Commission's belief that a three-rate VAT system unduly complicates tax matters,<sup>243</sup> this consideration suggests that Article

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240. Sixth VAT Directive, *supra* note 1, art. 28(2)(e), as amended by Council Directive 92/77, *supra* note 1, art. 1(4) at 2-3.

241. Terra, *Removal of Fiscal Frontiers: The Approximation of VAT Rates*, *supra* note 227, at 6-7.

242. These considerations are discussed *infra* Part VI.

243. According to the Global Communication from the Commission on Completion of the Internal Market: Approximation of Indirect Tax Rates and Harmonization of Indirect Tax Structure, COM(87)320 final at 2 [hereinafter Global Communication], "[t]here is little doubt that a three-rate

28(2)(e) derogations merit as high priority for abolition as do Article 28(2)(b) derogations.<sup>244</sup>

The sixth derogation relates only to certain Greek departments and islands, and it is not considered here.<sup>245</sup>

## VI. PROSPECTS FOR FURTHER HARMONIZATION AND ADOPTION OF THE ORIGIN PRINCIPLE

The first section of this Part examines prospects for further harmonization through abolition of derogations and through unification of VAT rates. Member States may resist further harmonization along these lines because of budgetary considerations, potential inflationary effects, economic dislocation, political problems associated with abolishing reduced rates for socially sensitive products, and the difficulties it poses for Member States to meet admission criteria for Monetary Union.

The second section examines the ramifications of adopting the origin principle and considers options for resolving the revenue loss and economic dislocation it may create for some Member States.

### A. *Rate Unification and Abolition of Derogations*

Greater harmonization of the VAT can be achieved by adopting a more unified rate structure and by eliminating derogations that grant special tax treatment for particular industries, countries or products.<sup>246</sup> A more unified rate structure can be achieved by placing an upper band on the standard 15% minimum rate, abolishing lower rates, or establishing one single rate for all goods and services subject to VAT.

Despite the adoption of a "standard rate," the persistence of multiple rates, retention of extensive derogations, and provisions under which more derogations may be approved<sup>247</sup> indicate that further harmonization in this area will remain

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system creates more complications for both taxpayers and national administrations and that it would therefore be simpler and more cost-effective to move to a two-rate system than to oblige those Member States who currently do not apply an increased rate to move to a three-rate system."

244. The Sixth VAT Directive, *supra* note 1, art. 12(2)(b), as amended by Council Directive 92/77, *supra* note 1, art. 1(1), at 1.

245. *Id.* art. 28(2)(f), as amended by Council Directive 92/77, *supra* note 1, art. 1(4), at 3.

246. Note that the difference between unification of rates and abolition of derogations is largely definitional in nature, but not without practical effect. Generally, unification converges rates across the board, while derogations permit exceptions on a case-by-case basis, usually with regard to specific territories, products, industries, or activities. Depending upon the nature of the derogation, whether it permits products to fall outside the VAT tax mechanism altogether, or merely allows for application of a lower rate, its abolition can be classified either as harmonization of base or rates, respectively.

247. A number of derogations have been enacted or proposed. For example, Council Decision 93/110 of 15 February 1993, 1993 O.J. (L 43), authorized France to derogate in its tax treatment with respect to the waste recovery industry. Council Decision 93/111 of 15 February 1993, 1993 O.J. (L 43), authorized the United Kingdom to apply a special collection scheme to certain enterprises with annual turnovers of less than £350,000. Council Decision 92/543 of 23 November 1992, 1992 O.J. (L 351), authorized Germany to exempt from tax supplies of credit services, and manage-

an issue for future debate. They also underscore the weakness of Community organs in areas that, although central to a Single Market, are still regarded as domestic matters, and the inability of the Community and Member States to find acceptable solutions to collateral problems engendered by harmonization. Because rate unification and abolition of derogations may have similar consequences for Member States, they are considered together.

### 1. Benefits of Further Harmonization

The arguments for further rate unification and abolition of derogations include: improving the functioning of the VAT system, achieving complete VAT harmonization at the Community level, avoiding distortion of competition among Member States, alleviating the derogations' significant impact on the method of calculating resources and facilitating control, ensuring equal tax treatment among the Member States in accordance with the EEC Treaty,<sup>248</sup> and closing avenues for tax evasion.<sup>249</sup>

A "pure" VAT regime would abolish all derogations and establish a single rate for all goods and services, thus achieving the greatest level of simplicity, and thereby rendering the greatest value in terms of the enumerated benefits.<sup>250</sup>

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ment and credit guarantees by an entity other than the grantor of the credits. Council Decision 92/544 of 23 November 1992, 1992 O.J. (L 351), authorized France to withhold at source the tax due from authors on royalties they receive and to utilize flat rate percentages in calculating deductions. Council Decision 92/545 of 23 November 1992, 1992 O.J. (L 351), authorized the Netherlands to levy a special tax on ready-to-wear-clothing. Council Decision 92/546 of 23 November 1992, 1992 O.J. (L 351), authorized the United Kingdom to use the open market value as the taxable amount for intra-Community acquisitions of goods if the purchaser is not a fully taxable person and if certain ties exist between the purchaser and the supplier of goods. In addition, the Economic and Social Committee in its opinion on VAT derogations recommended the introduction of several exemptions from VAT for sporting events; undertaking and cremation services; transactions carried out by blind persons; construction and maintenance of cemeteries, graves, and war monuments; telecommunications services; and the supply of water by public authorities. The Committee also recommended that any abolition of derogations for exemption of legal and other professional services should be offset by providing Member States the option to replace the derogation. Opinion of the Economic and Social Committee on the Proposal for a Council Directive on the Harmonization of the Laws of the Member States Relating to Turnover Taxes, Economic and Social Committee Report, § 3.4, 1992 O.J. (C 332)[hereinafter Opinion of the Committee].

248. These arguments were enumerated by the Economic and Social Committee in its report on the abolition of derogations. See Opinion of the Committee, *supra* note 247, § 3.4.

249. Multiple rates "invite evasion by misspecification." ALAN A. TAIT, *VALUE-ADDED TAX: INTERNATIONAL PRACTICE AND PROBLEMS* 315 (1988).

250. "The advantages of a single-rate tax with a very broad base are evident and generally appreciated by governments: greater revenue potential and simplicity, neutrality towards consumers and different types of business, reduced administrative costs of governments and compliance costs for traders and built-in resistance against particular pressure groups for lower rates or exemption." OECD, *supra* note 8, ¶ 1.36, at 36. Tait gives eleven reasons against multiple rates: (1) they distort consumer and producer choices; (2) traders may mark up low-taxed items to cross-subsidize higher taxed goods; (3) it is an inefficient way to protect the poor as it also benefits the rich; (4) "administered" prices should pay full VAT; (5) borderline disputes are created, and huge potential is opened up for lobbying; (6) high-quality staff time is wasted in dealing with demarcation disputes; (7) the tax base is eroded; (8) the high rates yield little revenue yet involve administrative costs; (9) differential rates rarely reflect genuine consumer choices and weights; (10) welfare gains are sacrificed; (11) the string of VAT uniformity is undermined. Tait, *supra* note 9, at 7.

## 2. *Obstacles and Problems*

Despite the recognition of the benefits of a "pure" VAT, considerable doubt exists among Member States and within Community organs as to whether a complete harmonization of rates or abolition of derogations is necessary or desirable.<sup>251</sup>

The Cockfield Committee, which studied rate unification, favored giving Member States greater discretion to set rates. It proposed that rates need only be approximated within a rate band of 14 to 20% without fear of distorting competition among Member States.<sup>252</sup> Its conclusions were based, in part, upon studies showing that different sales tax rates in the United States do not cause intolerable market distortions between bordering states.<sup>253</sup> It also relied heavily on the theory that Member States would be reluctant to impose extraordinarily high VAT rates for fear of putting their products at a competitive disadvantage.<sup>254</sup> Based upon revenue considerations and the reasoning put forward by the Cockfield Committee, the Council of Finance Ministers (ECOFIN) on June 24, 1991 adopted an even more flexible approach, selecting a minimum rate of 15% and abandoning the upper rate limitation altogether.<sup>255</sup> This was codified in Council Directive 92/77.

The budgetary and economic problems encountered during the recent approximation of January 1, 1993 suggest that Member States may resist further

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251. The Commission recognized this tension between the ideal solution and the proposal it eventually made in its Global Communication, *supra* note 243, at 2 ("Thus, although the Commission accepts that, in theory, a VAT system with only one rate is the simplest and most efficient structure, it is clear that such an approach would have disruptive consequences for all Member States, other than [Denmark and the United Kingdom], and is unlikely to be acceptable to the Community as a whole. It is therefore proposed that a multi-rate system should be adopted.")

252. The Cockfield Report, *supra* note 32, first considered rate bands of between 14-19% with a Community average of 16.5%; its later proposal was slightly modified with an upper rate band of 20%. See Global Communication, *supra* note 243.

253. See, e.g., William F. Fox, *Tax Structure and the Location of Economic Activity Along State Borders*, 39 NAT'L TAX J. 387 (1986) (retail sales tax differentials exert only a modest influence on the location of economic activity along state's borders, and only influence a low percentage of sales); see also Michael J. Walsh & Jonathan D. Jones, *More Evidence on the 'Border Tax' Effect: The Case of West Virginia, 1979-84*, 41 NAT'L TAX J. 261, 261-65 (1988) (empirical evidence showing border tax differentials induce cross border shopping when the value of tax savings exceeds the transportation costs associated with obtaining the tax savings).

254. The theory of "tax competition" suggests that competitive pressures among taxing jurisdictions will lead to near-uniformity of rates. In the context of the European Market, economists have argued that the completion of the common market will foster tax competition. For these arguments, see B. EICHENGREEN, *COSTS AND BENEFITS OF EUROPEAN MONETARY UNIFICATION* (Center for Economic Policy Research Discussion Paper No. 453, 1990); F. VAN DER PLOEG, *BUDGETARY ASPECTS OF ECONOMICS AND MONETARY INTEGRATION IN EUROPE* (Center for Economic Policy Research Discussion Paper No. 492, 1991); A. Giovannini, *National Tax Systems Versus the European Capital Market*, 9 ECON. POL'Y 345 (1989). For an analysis of the advantages and disadvantages of tax competition, see Charles E. McLure, Jr., *Tax Competition: Is What's Good for the Private Goose Also Good for the Public Gander?*, 39 NAT'L TAX J. 341 (1986) (countering the argument that tax competition will lead to sub-optimal spending on public services with the proposition that it may promote financing that more closely reflects the benefits of public services to their recipients).

255. Tony Westaway, *The Fiscal Dimension of 1992 in THE SINGLE EUROPEAN MARKET AND BEYOND 93-94* (Dennis Swann ed., 1992).

harmonization. States lowering their rates suffered revenue loss and budget deficits. Ireland's Minister of Finance announced in his 1993 Financial Statement that the "abolition of [higher] VAT on goods from other EC Member States will cost at least IR £25 million" in government revenues.<sup>256</sup> Other estimates predict Ireland's cash flow loss will be between IR £200 million and IR £400 million.<sup>257</sup> Greek authorities have also complained of losses arising from the reduction of their highest rates.<sup>258</sup>

States forced to raise rates to comply with the 15% floor complained that the approximation negatively affected economic growth. In March 1993, the Confederation of British Industry's report on the economy partly blamed VAT tax increases for a projected sluggish economy and predicted that VAT increases will "serve to hold back the growth in consumer spending."<sup>259</sup>

A tax increase that causes a reduction in consumption may cause other negative economic consequences such as reductions in output and investment, and higher unemployment.<sup>260</sup> Although it is not clear how serious these side effects would be,<sup>261</sup> obtaining the agreement of the Member States to implement further harmonization may require some assurances that these effects would be minimal, that offsetting adjustments can be made on an individual basis, or that Community relief would be provided.<sup>262</sup>

Social and political considerations also present obstacles for further VAT harmonization. Reduced rates are applied to cultural, essential, and sensitive goods and services partly because of public sentiment,<sup>263</sup> and partly to counter-

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256. *Ireland's Minister for Finance Unveils 1993 Financial Statement*, TAX NOTES INT'L, Apr. 19, 1993, available in LEXIS, Taxana Library, TNI File. Ireland's compliance with Council Directive 92/77, *supra* note 1, eliminated their 10% and 16% rate brackets, leaving the 0%, 2.5%, 12.5%, and 21% rates still in effect. *VAT Around the World*, INT'L VAT MONITOR, May 1993, at 22.

257. *VAT Around the World*, *supra* note 256, at 21.

258. *Greece's Lower Revenues Resulting in Stepped-up Enforcement*, 6 TAX NOTES INT'L 1256, 1256 (1993) [hereinafter *Greece's Lower Revenues*].

259. *British Business Group Issues CBI Economic Situation Report*, TAX NOTES INT'L, May 19, 1993, available in LEXIS, Taxana Library, TNI File.

260. See Jacob A. Frenkel et al., *International VAT Harmonization*, 38 IMF STAFF PAPERS 789 (1991) (Frenkel, Razin, and Symansky argue that VAT harmonization significantly affects such variables as output, employment, investment, consumption, interest rate, current account, and value of external debt differently among countries and within countries; and discusses the possible conflicts of interest this may cause).

261. See Charles R. Bean, *Economic and Monetary Union in Europe*, 6 J. ECON. PERSPECTIVES 31, 49 (1992) (noting that individual tax decisions of the Member States are less likely to cause labor and capital to migrate than in the United States because European labor mobility is lower and because linguistic and cultural heterogeneity will continue even after 1992); Harry Flam, *Product Markets and 1992: Full Integration, Large Gains?*, 6 J. ECON. PERSPECTIVES 7, 10-14 (1992) (arguing that goods and services are less likely to have substitutes in the context of a European Market as readily as they do in the United States, and that enterprise and labor are less likely to migrate than traditionally believed).

262. Offsetting adjustments are discussed in this section of Part VI; community relief is discussed *infra* Part VI(B), which considers the adoption of the origin principle.

263. The political problems associated with abolishing reduced rates for socially sensitive products are only briefly discussed in this article as they are well understood and covered elsewhere. For a full discussion, see TART, *supra* note 249, at 49-79.

act the regressive nature of the VAT.<sup>264</sup> VAT rates are also used to pursue policy goals. For instance, low rates subsidize newspapers and the media; high rates discourage such practices as pornography and alcohol consumption. With further approximation, new ways of achieving these social policies may have to be pursued. While the Commission argues that it is more economically efficient to subsidize programs directly, it remains an open question whether governments that were previously willing to accomplish their ends through VAT rates will agree to support new programs or overtly pursue a campaign to influence private morality.

The prospects for further VAT harmonization must also be considered in light of the proposed Monetary Union.<sup>265</sup> It is not clear whether further VAT harmonization would help or hinder the ability of Member States to meet the

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264. Economists debate whether multiple rates constitute an effective or appropriate method to counteract regressivity. See OECD, *supra* note 8, ¶¶ 8.5, 8.15-8.29, at 123-34 (discussing economic studies showing that convergence in consumption patterns of different income groups makes the use of multiple rates less important for increasing the progressivity of the VAT); see also Tait, *supra* note 9, at 7 (noting that multiple rates are inappropriate for this purpose because they benefit the rich as much as the poor).

265. Progress towards Monetary Union has been divided into three stages. Stage one commenced July 1, 1990. It required all Community currencies to participate in the exchange rate mechanism (ERM) of the European Monetary System (EMS), removal of all obstacles to financial integration, and an intensification of monetary coordination. COMMITTEE FOR THE STUDY OF ECONOMIC AND MONETARY UNION, REPORT ON ECONOMIC AND MONETARY UNION IN THE EUROPEAN COMMUNITY ¶ 52 (1989).

The EMS, which commenced March 13, 1979 obligates participating Member States to buy or sell each others' currencies according to a parity grid in order to maintain currency stability. Its goal is to lessen the risk associated with settling balance of payments and to prepare for adoption of one currency. The parity grid originally specified a 2.25% band of fluctuation above or below a central rate set for each currency. Italy, Spain and Portugal were allowed a temporary margin of 6% above or below their respective central rates. The band was recently widened on August 2, 1993 to allow fluctuation within 15% below or above central rates for all countries except between Germany and the Netherlands, who agreed to maintain the original 2.25% fluctuation range. Central rates are target rates which are arrived at by setting one ECU equal to a fixed percentage of each participating State's currency. Changes in the target rates are known as realignments and are achieved by adjusting the percentage of each currency to the ECU.

Stage two commenced January 1, 1994. It involves the creation of the European Monetary Institute (EMI) which assumed the responsibilities of the European Monetary Cooperation Fund. EMI will begin to organize the central banks of the Member States under the European System of Central Banks (ESCB) and to prepare the way for the European Central Bank (ECB), both of which will be fully operational in stage three. The EMI also issues guidelines for monetary, regulatory, and fiscal co-ordination and conducts policy surveillance. Treaty Establishing the European Economic Community, Mar., 25, 1957, arts. 109f, 109g, 298 U.N.T.S. 11, *amended by* The Treaty on European Union, Feb. 7, 1992, art. G(25), 31 I.L.M. 247 [hereinafter EEC Treaty]. Also during stage two, the excessive deficit procedure enters into force and central banks are prohibited from monetizing debt created by public entities. *Id.* arts. 104, 104b, 104c.

Stage three involves the irrevocable locking of exchange rates, and the assumption of full control over monetary policy by the ESCB. A single currency could be introduced during the third stage. See *infra* note 266 for the proposed dates of stage three's commencement. For a history of the EMS prior to Maastricht and a discussion of its operation, see JACQUES VAN YPERSELE & JEAN-CLAUDE KOEUNE, THE EUROPEAN MONETARY SYSTEM: ORIGINS, OPERATION AND OUTLOOK (Commission of the European Communities, 1984). For a discussion of the post-Maastricht arrangements, see PETER B. KENAN, EMU AFTER MAASTRICHT, GROUP OF THIRTY (1992). For a discussion of the Ecu and its composition, see *The Ecu and Its Role in the Process Towards Monetary Union*, EUROPEAN ECON., Sept. 1991, at 115-48.

criteria for admission into the third and final stage of Monetary Union scheduled for no later than January 1, 1999.<sup>266</sup>

In order to qualify for admission into Monetary Union, Member States must satisfy four criteria indicative of the requisite economic convergence. First, the Member State must have a consumer price inflation rate (observed over a period of one year prior to the examination) of no more than 1.5 percentage points above the average for the three Member States with the lowest inflation rates.<sup>267</sup> Second, the Member State is required to maintain its exchange rate within the normal<sup>268</sup> fluctuation margins of the European Monetary System for at least the last two years before the examination. The Member State must not devalue its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period.<sup>269</sup> Third, the Member State is to maintain nominal long-term interest rates over a period of one year prior to the examination that are no more than 2 percentage points above those for the three Member States with the lowest inflation rates.<sup>270</sup> Finally, the Member State must achieve a sustainable budgetary position, which is interpreted to mean that planned or actual government deficits should not exceed 3% of gross domestic product, and total government debt should not exceed 60% of gross domestic product.<sup>271</sup>

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266. The commencement date for stage three is variable. If the Member States can reach an agreement by December 31, 1996 and a majority qualify for Monetary Union at that time, it would begin on a date set by the Council. EEC Treaty, *supra* note 265, art. 109j(3). If no date is set by the end of 1997, it will begin on January 1, 1999 if at least two countries qualify. *Id.* art. 109(j)(4). Member States that do not qualify for Monetary Union at that time may do so at a later date under the procedures of Article 109k. A comparison of the schedules for VAT harmonization and Monetary Union suggests that both must be considered together. Review of VAT derogations with a view to their elimination are to take place every two years. Sixth VAT Directive, *supra* note 1, arts. 34, 35. The proposed switch to the origin principle is scheduled to take place by December 31, 1996. *Id.* art. 281, *as amended* by Council Directive 91/680, *supra* note 1, art. 1(22) at 17.

267. EEC Treaty, *supra* note 265, art. 109j(1); Protocol on the Convergence Criteria Referred to in Article 109j of The Treaty Establishing the European Community, art. 1, 31 I.L.M. 352, 353 [hereinafter Protocol on the Convergence Criteria].

268. It was originally assumed among economists that "normal" means a 2.25% fluctuation band. This remains the position of the German Central Bank. This interpretation is supported by the fact that the 15% band was not introduced until August 2, 1993, after the Maastricht Treaty was drafted. It is not clear, however, how the European Court of Justice would rule on this issue if challenged. The provision's language was left ambiguous intentionally and there is no longer consensus on this point.

269. EEC Treaty, *supra* note 265, art. 109j(1); Protocol on the Convergence Criteria, *supra* note 267, art. 3.

270. EEC Treaty, *supra* note 265, art. 109j(1); Protocol on the Convergence Criteria, *supra* note 267, art. 4. Note that it is not clear whether an average is intended by the Treaty or not.

271. EEC Treaty, *supra* note 265, art. 104c(2); Protocol on the Excessive Deficit Procedure, art. 1, 31 I.L.M. 352, 352 [hereinafter Excessive Deficit Protocol]; *see also* Council Regulation 3605/93 of 22 November 1993, O.J. (L 332) 7, which defines essential terms in order to apply the Excessive Deficit Protocol. Note that these requirements are not enforced mechanically. The Council may make exceptions if the excessive deficit is temporary or the debt ratio is declining. EEC Treaty, *supra* note 265, art. 104c(2)(b). In the event that the Council finds that an excessive budget deficit exists in a Member State, the Council is empowered under Article 104c(6) to make recommendations to the Member State. If the situation persists, Article 104c(11) allows the Council to use various methods to correct the situation including inviting the European Investment Bank to recon-

In some respects, further harmonization appears to collide with the goals of Monetary Union. For example, meeting the inflation target may be difficult to the extent that a rise in VAT rates will increase inflation in some Member States and not in others. This is most likely to occur where individual derogations applicable to certain Member States are abolished, or where the unification of VAT rates increases the overall tax burden more heavily in only some of the Member States.

Economists take issue with the claim that an increase in VAT rates will necessarily cause inflation. According to one view, a one-time increase in the VAT will not cause inflation in the long run to the extent that increased prices will dampen demand. Eventually, prices should re-adjust downward to bring the inflation rate back into line. Others argue that introduction of a VAT need not be inflationary if adjustments can be made to other tax systems or fiscal policy.<sup>272</sup> If VAT harmonization is accomplished sufficiently prior to the examination for admission into Monetary Union, then Member States may have time to make adjustments and neutralize any inflationary effects in an effort to meet these targets. If Member States are unable to neutralize inflation, due either to the timing of VAT harmonization or because adjustments were ineffective, the Council may use its discretion in conducting the examination to consider the reasons for the inflation and, if adjustments have in fact been made, the likelihood of eventual correction.

Similar considerations apply to the interest rate and exchange rate criteria. Theoretically, a harmonization of VAT that increases tax rates should cause a fall in interest rates and a weakening of the currency.<sup>273</sup> This follows because a tax hike depresses private sector activity, thereby lowering the demand for

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sider its lending policies toward the Member State, requiring the Member State to make a non-interest-bearing deposit with the Community, and in stage three, imposing fines.

272. Under this view, to the extent that VAT is passed forward as part of the price of goods and services, the consumer will pay more and the Consumer Price Index will at least temporarily rise. Where the introduction of a VAT only serves as a replacement for other taxes, the relative prices of goods may change but an overall rise in the total tax burden need not occur. For this view, see John C. Grech, *VAT And Inflation*, INT'L VAT MONITOR, Mar. 1993, at 6-8; Tait, *supra* note 9, at 7-8. Tait reviewed the results of an IMF survey of the inflationary effects of VAT in 35 countries, and concludes: "If it replaces an existing, equal-yield tax, there may be changes in relative prices, but no overall price increase. Indeed, even if the VAT generates a net rise in revenue, a tax increase should be deflationary rather than inflationary. It is only if other actions are taken—for example, through indexation and increased money supply—that a general price increase could occur. In other words, it is not the VAT itself that can be inflationary but other accompanying policies that make it so." Tait, *supra* note 9, at 7-8. He notes that minimization of the inflationary side-effects of VAT can be achieved by timing its introduction to coincide with a time of disinflation, price controls, and offsetting adjustments in other taxes. *Id.*; see also TAIT, *supra* note 249, 191-213 (reviewing empirical data from different countries).

273. The example assumes that no offsetting policy is adopted. For instance, a Member State might counter a recessionary fiscal policy by increasing spending or by making adjustments in other tax policies. Without any adjustments, the Member State may suffer higher unemployment until interest rates are sufficiently low so as to encourage greater economic activity. In such a situation, the Member State's central bank might increase the supply of money to spur activity, but this action could further prevent the Member State from achieving its interest rate goals. In the long-run, economic activity should eventually increase, causing interest rates and exchange rates to re-adjust.

money and causing a drop in interest rates. Interest rates may be further depressed to the extent that increased taxes raise additional revenue and reduce the amount of government securities Member States sell on the open market to finance debt. In turn, the drop in interest rates may cause a capital outflow from the Member State, as investors look for higher returns elsewhere. The reduced domestic and international demand for the Member State's currency may cause it to drop below its exchange rate margin.

The extent to which a tax hike would affect exchange rates and interest rates is not clear. As with inflation, the timing of tax increases and offsetting adjustments in other areas should be utilized to counter the negative effects that result from harmonization. If an increase in VAT frustrated a Member State in achieving its interest rate and exchange rate targets, the Council should consider this together with the likelihood of eventual correction in its examination.

In other respects, the goals of the Monetary Union and further VAT harmonization compliment each other. This is particularly true with regard to the budget criteria. VAT harmonization may provide the Community with an ideal means to compel Member States to raise the revenue necessary to reduce excessive budget deficits.<sup>274</sup> Further harmonization of the VAT rate structure that eliminates lower rates would provide additional revenue to Member States having difficulty complying with the budgetary requirement of Monetary Union.<sup>275</sup> Such harmonization would move countries such as Italy, Greece, Belgium, Ireland, and the Netherlands in a direction towards sustainable deficits.<sup>276</sup> In light

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274. The magnitude of the task of meeting the budget guidelines set by Maastricht is worth considering at this point. In order to meet the targets, Greece will have to increase taxes or cut public spending by approximately 10.5% of national income to stabilize its debt-to-GDP ratio (assuming real interest rates are at 4 percent). MICHAEL EMERSON & CHRISTOPHER HUHNE, *THE ECU REPORT 84* (1991); see William Buiter et al., *Excessive Deficits: Sense and Nonsense in the Treaty of Maastricht*, *ECON. POL'Y*, Apr. 1993, at 58, 64-72 (Buiter, Corsetti, and Roubini analyze the strain that Monetary Union targets will place on each Member State's fiscal policy).

275. Statistics illustrate the additional revenue that could be raised in some Member States by abolishing lower rates. According to the Commission, reduced rates represent approximately one third of the common Community tax base. Global Communication, *supra* note 243, at 2. The following represents the percentage of VAT yields obtained at the lower reduced rates: 40% in Belgium, 0% in Denmark, 5% in France, 10% in Germany, 43% in Ireland, 25% in Italy, 45% in Luxembourg, 10% in the Netherlands, 28% in Portugal, 31% in Spain and 0% in the United Kingdom. OECD, *supra* note 8, at 84 tbl. 5.3 (figures for Greece not available). In contrast, revenue from higher rates are only approximately 5-7% of the Community tax base. COMMISSION OF THE EUROPEAN COMMUNITIES, *REPORT ON THE SCOPE FOR CONVERGENCE OF TAX SYSTEMS IN THE COMMUNITY 25-26* (European Community Bulletin, 1980 & Supp. I). The practice of zero-rating, which applies a 0% rate with a right to deduction, illustrates the revenue loss caused by reduced rates. According to Tait, "Zero rating can knock out up to 40 percent of the tax base. Clothing can represent 10 percent, and housing 10-15 percent of household spending." Tait, *supra* note 9, at 6.

276. Corsetti and Roubini have analyzed whether the individual fiscal policies of the Member States are sustainable, and have concluded that Italy, Greece, Belgium, Ireland, and the Netherlands will experience problems. GIANCARLO CORSETTI & NOURIEL ROUBINI, *FISCAL DEFICITS, PUBLIC DEBT AND GOVERNMENT SOLVENCY: EVIDENCE FROM OECD COUNTRIES* (National Bureau of Economic research Working Paper No. 3658, 1991). Giovannini and Spaventa have reached similar conclusions, but predict better results for Belgium and Ireland. A. GIOVANNINI & L. SPAVENTA, *FISCAL RULES IN THE EUROPEAN MONETARY UNION: A NO-ENTRY CLAUSE* (Center for Economic Policy Research Discussion Paper 516, 1991). All of these Member States maintain one or more

of the Council's recent announcement that a number of Member States will not meet the target date of 1996 for achieving their budgetary goals,<sup>277</sup> the Commission could utilize VAT harmonization to improve the position of these Member States for admission into Monetary Union.<sup>278</sup> Indeed, a uniform increase in VAT rates across the Community may be the ideal method to raise revenue because it obviates the reluctance of States to raise tax levels for fear of tax bases leaving to other Member States.<sup>279</sup>

The intersection of VAT harmonization and Monetary Union must also be considered within the context of a larger debate among economists over whether further fiscal harmonization is necessary or desirable in the context of Monetary Union.<sup>280</sup> As VAT is a major component of fiscal policy for Member States,<sup>281</sup>

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reduced rates that apply to significant components of the tax base such as food, housing, and clothing. See *infra* Appendix B for rates in Member States. Note that too sharp an increase in taxes may dampen demand sufficiently to cause a reduction in tax revenue.

277. Under its authority to issue broad guidelines on the economic policies of the Member States, the Council recently issued a recommendation providing guidance for sound public finances. The recommendation admonishes Member States facing high budget deficits to intensify their consolidation efforts, and instructs the others to maintain tight budgetary control with an emphasis on credible medium-term consolidation strategies. In light of the projected growth rate, the recommendation asserts that most Member States have the potential to reach their budgetary goals by 1996, while others will need more time. Council Recommendation 94/7 of 22 December 1993, 1993 O.J. (L 7) 9.

278. Other means to achieve reductions in budget deficits include a reduction in spending. This is theoretically encouraged by market forces in the form of higher interest rates as a means to induce greater budgetary discipline. This approach is implicit in Articles 104, 104a, and 104b, of the EEC Treaty, *supra* note 265, which prohibits the ESCB from financing the debt of Member States even in financial crisis, thereby preventing policymakers from running up large deficits.

There are, however, doubts about whether these methods will work. It is not clear that the no bail-out provision of the Treaty is credible. Also, in the context of Monetary Union, fiscal policy decisions in individual Member States may have very little influence on the common Ecu interest rate. See EMERSON & HUHNE, *supra* note 274, at 85-87. Past experience also suggests that market forces are inadequate, and that something more is necessary to bring budgets into line. See Jacob A. Frenkel & Morris Goldstein, *Monetary Policy in An Emerging EMU*, 38 IMF STAFF PAPERS 356, 367-70 (1988) (noting that interest rates on government debt have not proven to accurately reflect actual risk of default associated with large budget deficits and have therefore not provided the necessary discipline); GIANCARLO CORSETTI & NOURIEL ROUBINI, TAX SMOOTHING DISCRETION VERSUS BALANCED BUDGET RULES IN THE PRESENCE OF POLITICALLY MOTIVATED FISCAL DEFICITS: THE DESIGN OF OPTIMAL FISCAL RULES FOR EUROPE AFTER 1992 (Center for Economic Policy Research Discussion Paper No. 682, 1992) (noting that in light of politically motivated deficits that appear to be systemic in nature, a credible external enforcement mechanism is needed to monitor and apply explicit sanctions against Member States that persist with fiscal policies that diverge from agreed goals).

279. A sharp rise in tax rates could promote migration of the tax base. In the case of a uniform reform, migration problems are avoided depending upon other tax policies. See A. Lans Bovenberg et al., *Economic and Monetary Union in Europe and Constraints on National Budgetary Policies*, 38 IMF STAFF PAPERS 374, 377-79 (1991) (Bovenberg, Kremers, and Masson argue that higher mobility within the Community will make it increasingly difficult for Member States to raise surplus revenue because such tax hikes may cause tax base migration).

280. See, e.g., William Buiter et al., *supra* note 274, at 58 (noting that treaty restrictions against running excessive deficits may be harmful. Instead, an active fiscal policy able to respond to changing circumstances is necessary to avoid damage to Monetary Union. Buiter, Corsetti, and Roubini thus strongly favor greater fiscal flexibility); Reuven Glick & Michael Hutchison, *Fiscal Policy in Monetary Unions: Implications for Europe*, 4 OPEN ECON. REV. 39 (1993) (asserting that the ability to maintain fiscal independence will be reduced with greater monetary integration); see also Jay H.

this debate will certainly influence whether the VAT should be further harmonized.

According to one view, greater flexibility in fiscal matters is desirable in the context of Monetary Union because individual Member States and their central banks lose their autonomy with regard to monetary policy in stage two.<sup>282</sup> Harmonization of VAT and the concomitant loss of flexibility in fiscal matters would deprive Member States of the full use of fiscal means to resolve economic problems.<sup>283</sup> A rigid rate structure, for instance, would reduce the ability of Member States to use the VAT as a mechanism to stimulate their own domestic economies. This flexibility can be especially important for Member States that must respond to domestic problems that are unique to their individual countries<sup>284</sup> and for States

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Bryson et al., *Rules, Discretion, and International Monetary and Fiscal Policy Coordination*, 4 OPEN ECON. REV. 117 (1993) (examining tradeoffs of both international monetary and fiscal policy coordination and concluding that coordination has ambiguous effect; international coordination of fiscal policy for interdependent nations that coordinate their monetary policies raises output at the expense of higher inflation and lower public spending); A.J. Hughes Hallett & D. Vines, *On The Possible Costs of European Monetary Union*, 61 THE MANCHESTER SCHOOL 35 (1993) (arguing that in order to make monetary policy effective, fiscal policy should be coordinated with monetary policy, and possibly, among Member States); Paul Levine, *Fiscal Policy Co-ordination Under EMU And The Choice Of Monetary Instrument*, 61 THE MANCHESTER SCHOOL supp. 1 (1993) (concluding that the choice of monetary instrument determines whether greater fiscal harmonization is desirable: if the ECB sets the nominal interest rate, greater fiscal co-ordination is counterproductive; if the ECB sets inflation, then fiscal co-ordination is welfare enhancing).

281. The role of VAT is illustrated by the following statistics. VAT accounted for 20-25% of total tax revenues in the Member States in 1990. The figures are as follows: Denmark, 19.4%; Greece, 25.3%; France, 19.7%; Ireland, 20.7%; the Netherlands, 16.5%; Belgium, 16.2%; Portugal, 20.4%; United Kingdom, 16.5%; Luxembourg, 14.2%; Germany, 15.6%; Italy, 15.2%; Spain, 17.1%. ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, THE ROLE OF TAX REFORM IN CENTRAL AND EASTERN EUROPEAN ECONOMIES, tbl. 7, at 381 (1991).

282. For a discussion of stage two, see *supra* note 265. European Central banks had already lost some autonomy prior to stage two to the extent that they were committed to maintain their exchange rates within fluctuation bands. The European currency crisis of Fall 1992 arose when several Member States (primarily the United Kingdom, Spain, Portugal, and Italy) were no longer willing to keep their interest rates high enough to maintain currency values with respect to the German mark.

283. This can be seen in the following hypothetical: if a single Member State's economy is hit by a sudden rise in demand caused by households' desire to spend more and save less (demand shock) which is large enough to pose some inflationary danger, monetary policy could respond by increasing interest rates to curb home demand and raise the exchange rate. The rise in the currency would cut import prices, which would in turn keep down the prices and profit margins of companies competing with imports. The inflationary impact of the shock would be small, and if savings rapidly re-adjust to its previous level, there would be little need for a further change in wages.

Since under Monetary Union the Community would respond minimally to a shock affecting one State, most of the burden of adjustment would fall on wages and prices. Without a sufficient response from monetary authorities, the increase in demand would increase imports and raise the domestic price level, which would in turn offset the effects of the rise in household demand. A timely tax increase by the State could, theoretically, be utilized to make the necessary adjustment so that prices would rise by less and that the subsequent adjustment, when savings resume their normal pattern, would be less damaging to output and employment. EMERSON & HUHNE, *supra* note 274, at 75-76.

284. Economists refer to problems affecting countries differently as "asymmetric shocks." Economists have further distinguished between asymmetric demand shocks and asymmetric supply shocks. Much research has been done on the subject of asymmetric shocks in the context of Euro-

that wish to respond to common problems according to individual policy preferences.<sup>285</sup>

Although it is doubtful whether fiscal policy constitutes an effective means of responding to short-term economic problems,<sup>286</sup> a consumption tax such as the VAT is said to provide a particularly efficient instrument for influencing macroeconomic policy, because it is likely to have a more rapid effect on aggregate purchases than would changes in other taxes.<sup>287</sup> Thus, under this view, further harmonization of the VAT should especially be avoided.

According to another view, greater fiscal harmonization is desirable in order to avoid the negative effects that differing fiscal policies among Member States may create in the context of Monetary Union. The concern is that inefficiency resulting from different tax policies may spill over from one Member State to another due to the greater mobility of capital, labor, and enterprise. For example, an unsustainable budget deficit of one Member State could cause an increase in interest rates throughout the Community. It is not yet clear whether spillover represents a significant concern.<sup>288</sup> The predominant view is that these

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pean fiscal and Monetary Union. Weber has found that shocks to aggregate supply in the European Community have been increasingly symmetric, but that demand shocks and labor-market shocks have been sufficiently asymmetric to justify using fiscal policies to achieve domestic stabilization. A. A. Weber, *EMU and Asymmetries and Adjustment Problems in the EMS—Some Empirical Evidence*, in *EUROPEAN ECONOMY*, SPECIAL EDITION NO. 1 (1991). Bayoumi and Eichengreen have found that supply shocks for the core EC countries (Germany, France, Denmark, Belgium, the Netherlands, and Luxembourg) are more symmetric than for the other Member States, which suggests that a two-speed Europe may be appropriate whereby faster monetary and fiscal integration takes place in these core countries than for the rest. T. BAYOUMI & BARRY EICHENGREEN, *SHOCKING ASPECTS OF EUROPEAN MONETARY UNIFICATION* (National Bureau of Economic Research Working Paper No. 3949, 1992); see also BARRY EICHENGREEN, *IS EUROPE AN OPTIMUM CURRENCY AREA?* (National Bureau of Economic Research Working Paper No. 3579, 1991); Barry Eichengreen, *One Money for Europe? Lessons from the U.S. Currency Union*, 10 *ECON. POL'Y* (1990); DE GRAUWE & W. VANHAVERBEKE, *IS EUROPE AN OPTIMUM CURRENCY AREA? EVIDENCE FROM REGIONAL DATA* (Center for Economic Policy Research Discussion Paper No. 555, 1991).

285. For a discussion of the policy preferences argument, see P. MASSON & J. MELITZ, *FISCAL POLICY INDEPENDENCE IN A EUROPEAN MONETARY UNION* (Center for Economic Policy Research Discussion Paper No. 414, 1990).

286. Fiscal policy is generally viewed as a poor substitute for monetary policy, because it is typically formulated annually, it is subject to political debate and therefore difficult to change, and it is difficult to forecast which yields unpredictable results. See, e.g., A. Steven Englander & Thomas Egebo, *Adjustment Under Fixed Exchange Rates, Application to the European Monetary Union*, in *EUROPEAN ECONOMIC STUDIES* NO. 207 (1993) (proposing that fiscal policy cannot provide a substitute mechanism where price adjustment of relative prices is needed to offset supply-side disturbances, its use is likely to be constrained in countries where government deficits are high, and Member States may have to rely on added flexibility of wages and prices with an emphasis on structural policies).

287. OECD, *supra* note 8, ¶ 1.20, at 33.

288. Buitert, Corsetti, and Roubini reject the "theoretical (efficiency) arguments for international coordination of virtually every aspect of budgetary policy." They do not believe that the international spillover of non-cooperative fiscal policies is sufficiently large, nor the effect sufficiently certain, that spillover may threaten the budgetary position of Member States. They note that "on balance, no convincing efficiency-based theoretical case has been made for a supranational coordination mechanism" in this area. Buitert et al., *supra* note 274, at 82.

concerns may be more theoretical than real, except in the possible case of Germany.<sup>289</sup>

### 3. Possible Solutions

Retention of derogations from the tax base may help Member States recoup lost revenues, counteract recessionary effects, control inflation, and respond differently to both symmetric and asymmetric economic problems that may result from further VAT rate unification.

The Economic and Social Committee recently made a proposal to this effect.<sup>290</sup> While the Committee felt that further abolition of derogations was desirable, it concluded that rate unification is far more important and supported the Commission's proposal to introduce new derogations as a tool to alleviate the "potential budgetary repercussions or probable inflationary effects" of further rate unification.<sup>291</sup> The Committee proposed abolition of only those derogations proven to cause distortion of trade.<sup>292</sup>

In addition to the economic considerations mentioned above, there are a number of advantages to the Commission's proposal to retain derogations that do not distort competition while unifying the rate structure. Retention of derogations allows resolution of problems without the need for Community-wide agreement or the involvement of centralized organizations. In addition, it enables Member States to avoid the difficult political problems associated with taxing sensitive products. Also, Member States will favor retention because it gives them greater discretion in social policy matters.

Derogations also offer an opportunity for small-scale experimentation that may be of value to the entire Community in determining which VAT arrangements work best. This may be of particular importance in developing schemes to prevent fraud and in efforts to simplify the VAT, both of which are commonly stated justifications for recent derogations.

Retention of derogations is not a perfect solution, however. It represents a partial abandonment of the goal of a Single Market with a uniform infrastructure. Derogations increase the level of complexity in intra-Community transactions and may become especially detrimental for smaller companies that wish to

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289. See EMERSON & HUHNE, *supra* note 274, at 88-90 (noting that fiscal expansion by Germany will cause substantial increase in interest rates throughout the Community, while fiscal expansion in other Member States will cause only slight increase in interest rates but will boost the GDP of their trading partners provided that a fiscal expansion pushes up the exchange rate; thus spillover presents a problem only in exceptional circumstances and fiscal policies need not be so closely harmonized).

290. Opinion of the Committee, *supra* note 247.

291. *Id.* §§ 2.8-2.9.

292. The Committee apparently believes that market distortion will not present a problem in most cases, and therefore, the most common arguments in favor of abolition are not persuasive. The Committee found that market distortion "is often not evident, or at any rate not of great significance." *Id.* § 1.2. It explained that this is because "some derogations are applied by a very small number of Member States. In addition, various factors, such as distance, convenience, [and] service . . . directly influence a purchaser's choice and therefore sometimes make the distortion purely theoretical." *Id.* § 2.10.

expand their trade throughout the Community, while performing their accounting from one location.<sup>293</sup> These companies may lack the resources to track the laws of all Member States in order to trade within them. Such derogations thus represent a barrier to trade.

Retention of derogations is also difficult to reconcile with the principles of equity in the context of a unified Single Market.<sup>294</sup> From the standpoint of the consumer, it is difficult to reconcile why the French pay less VAT tax on their newspapers than the Dutch. From the standpoint of industries or product groups, it is difficult to justify why certain companies or categories of products should be given an advantage. While there may be reasons to provide disparate treatment to certain regions or industries—such as in the form of direct aid for economically troubled industries—inconsistent application of the VAT may be an inappropriate method given the notions of equity embodied in a Single Market.

If derogations are retained in order to unify VAT rates, the arrangements adopted should be designed at the Community level to minimize revenue loss and inflationary problems and to reduce the magnitude of derogation from the VAT regime. One approach is to adopt a single rate that would be calibrated to make rate unification revenue positive or neutral for all countries. Member States that obtain large revenue surpluses, and thereby risk dampening their economy, can then make adjustments to other tax systems and policies, or retain some VAT derogations.<sup>295</sup>

If adoption of a single rate causes revenue loss for some Member States, the Community should provide guidance to States that adjust other policies to replace these revenues without causing unnecessary variation in the VAT system. Past experience from the January 1, 1993 rate harmonization suggests that the use of derogations may not be necessary in all cases, and that the choice of adjustments can advance or detract from the goal of VAT harmonization. For instance, Greek authorities stepped up enforcement of collections to make up for lost revenue caused in part by reductions in VAT rates.<sup>296</sup> This is a positive development as it leads to a more efficient tax administration.

Irish authorities, on the other hand, adopted an advance VAT payment system in order to speed collection for the 1993 fiscal year. Under this system, traders with annual net VAT payments in excess of IR £120,000 were required to remit a special payment on December 1, 1993 equaling 1/12 of their estimated net VAT payable for 1993.<sup>297</sup> Ireland's use of such a special mechanism in-

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293. See OECD, *supra* note 8, ¶¶ 6.13, 11.46.

294. Counter-arguments that no inequity results, based on the United States allowing individual states to levy sales taxes at different rates, are unconvincing here. The United States does not purport to be a "Single Market" in the manner of the European Community.

295. An important side-effect of changing from a multiple-rate to a single-rate VAT is that it may alter the relative prices of products with consequent effects on productivity and employment. OECD, *supra* note 8, ¶¶ 1.37, 8.45 (discussing experience of the Netherlands). The areas of adjustment or derogation could be selected to soften shocks to these sectors.

296. *Greece's Lower Revenues*, *supra* note 258, at 1287.

297. *VAT Around the World*, *supra* note 256, at 21.

roduces further variation in tax practices. Taken together, the Greek and Irish experiences suggest that further harmonization should be accompanied by Community guidelines on the choice of methods used to offset any resulting changes in revenue, if unnecessary variation in the VAT system is to be avoided.

The Community might consider granting some form of direct relief to Member States that lose revenue or suffer economic side effects caused by rate unification.<sup>298</sup> While direct relief could work in such a situation, it should not be utilized unless genuinely necessary. For this reason, direct relief is neither recommended nor discussed here. The proposal is discussed below, however, as a possible solution to the problems associated with adoption of the origin principle.

In conclusion, further rate unification does not appear to result in revenue losses or involve any economic side effects that cannot be offset by adjusting other tax systems or policies, or by retaining some derogations in the VAT system.

### B. Prospects for Adoption of the Origin Principle

The adoption of the origin principle would cause the collection and retention of VAT to take place in the Member State in which the good or service is produced.

This system creates two problems. First, under the current rate structure, collection of VAT in the Member State of origin would create an incentive to make purchases from suppliers in Member States charging a lower VAT rate. This problem can be solved either by adoption of a single rate or by bringing rates within a sufficiently narrow band to reduce incentives for such activity. Rate unification, depending upon how it is implemented, could cause an increase in the overall tax burden in some Member States and a reduction in others. This may, in turn, cause different economic consequences among Member States.

Second, adoption of the origin principle will create revenue losses for Member States running an intra-Community trade deficit,<sup>299</sup> while States with

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298. See Jacob A. Frenkel et al., *supra* note 260, at 821 (suggesting compensation scheme as possible means to resolve problems of conflicts of interest among countries caused by further VAT harmonization). This should not conflict with the Treaty provisions which prohibit the Community from assuming commitments of the central governments, regional, local or other public authorities. The provisions contain an exception for "specific project[s]," which can be more broadly interpreted by subsequent definition provided by council regulation. See Council Regulation 3603/93 of 13 December 1993, 1993 O.J. (L 332) 1, which specifies definitions for the application of the prohibitions referred to in Articles 104 and 104b(1) of the EEC Treaty, *supra* note 265, with the effect of giving the EMI and the central banks of the Member States more discretion under the Treaty.

299. These revenue losses may be offset in the long-run by an adjustment in the exchange rate that would reduce the cost of financing a Member States' balance of payments. This option will not be available after stage three locks-in exchange rates. Given the Monetary Union restrictions on exchange rate fluctuation, see *supra* note 268, the availability of this option is greatly reduced even now.

intra-Community surpluses will enjoy an increase in VAT revenue. Obtaining the agreement of Member States to adopt the origin principle will require some method under which Member States who are net revenue losers can replace those losses.

Since a non-distortionate, origin-based regime requires greater unification of VAT rates, the revenue problems caused by switchover to the origin principle and the revenue and economic problems caused by rate unification must be considered together.<sup>300</sup> Three approaches are discussed here.

The first option is to allow Member States to make offsetting adjustments in other VAT, tax, or domestic policies.<sup>301</sup> Although adjustments may solve the problems caused by rate unification, the discussion here assumes that switchover could cause ongoing revenue losses for Member States with intra-Community trade deficits that may be of such a structural nature and magnitude that they cannot be easily offset by VAT derogations or other slight adjustments.<sup>302</sup>

The second option is to compensate Member States injured by such a switchover with direct aid from the Community budget. Direct aid could be utilized to correct the problems of both revenue loss and inflation.

The third option is to solve revenue loss by setting a unified rate that is sufficiently high to result in net revenue gains for all Member States. As will be discussed, this eliminates the revenue loss caused by both adoption of the origin principle and rate unification, but may dampen the economies of Member States.

Both the second and third options are discussed below.

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300. Adoption of the origin principle should not cause inflation or a recession because it involves the same rate of tax being collected by a different Member State. This is true provided that the switchover does not result in consumers significantly shifting their purchasing to Member States that have the lowest rates. Under these conditions, adoption of the origin principle only causes revenue loss problems. Because the loss hinges on the Member State's trade deficit, this loss is structural in nature and slight adjustments are assumed to be insufficient to resolve them. Rate unification, on the other hand, involves both problems of revenue loss for Member States lowering their rates to meet agreed rates, and of a dampened economy for Member States raising their rates. Adjustments in other tax systems or policies are assumed sufficient to counteract the negative consequences of rate unification.

301. See W.R.M. Perraudin & T. Pujol, *European Fiscal Harmonization and the French Economy*, 38 IMF STAFF PAPERS 339 (1991)(noting that under an origin-based system higher rates of VAT would effectively discriminate against a Member State's own domestic industry and create large incentives for shopping across borders and migration of tax base. Equalization of rates would solve the distortion problem but would cause rate reductions in some Member States and rate increases in others with their attendant economic consequences. The article discusses what adjustments are necessary in France to make such a change of policy welfare enhancing).

302. Under the Economic and Social Committee's proposal for rate unification, allowing derogations only where market distortion does not occur may prove insufficient to make up for revenue loss caused by fundamental structural changes by virtue of the relatively few goods and services which would be suitable for derogation. *But see supra* note 301. Thus, while retention of derogations and other adjustments appear to be adequate to resolve any revenue problems associated with rate unification, the revenue problems resulting from adoption of the origin principle may require more than mere adjustments.

### 1. Direct Relief

Direct relief might take the form of a transfer payment from Member States that are revenue winners to those that are revenue losers. Such a solution need not involve the creation of a clearinghouse and could be achieved through domestic structures under Community supervision. One option is to adjust Member States' required contribution to the Community budget. Another option is to employ a formula which would redistribute VAT revenues among Member States' treasuries.<sup>303</sup>

Direct relief might also be achieved through a system of central purchasing. This could be used to compensate those States that experience economic downturn resulting from further harmonization. Such a system may be established by obligating Member States individually or by creating a Community organization to purchase goods from Member States that are experiencing economic difficulties. Central purchasing is objectionable for a number of reasons. First, compensating Member States that will be net revenue winners should be unnecessary. Member States suffering from a dampened economy can simply reduce other taxes in order to counteract inflationary effects. Indeed, these States are in the best position to make adjustments without Community help because their VAT revenues are higher. Second, such a program would be expensive to maintain and likely to create state-owned surpluses. Finally, by increasing demand, such purchases exacerbate inflation in these States.

The use of Community relief raises the question of whether it should be conducted on a temporary or permanent basis. In principle, Member States should only be compensated for economic effects which are attributable to the change in Community policy. After a period of time, it becomes more difficult to prove causation, as any number of intervening factors—such as trade conditions or other policies—begin to account for revenue differentials and economic side effects. Thus, transfer payments or central purchasing should be only a temporary device to cushion the initial blow, and thereafter, compensatory relief should cease.<sup>304</sup> Such a temporary approach also minimizes political objections that may arise.<sup>305</sup>

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303. A redistributive scheme is practiced in Canada. See Bovenberg & Horne, *supra* note 32, at 44.

304. It could also be argued that if sufficient warning is given to Member States no compensatory relief is appropriate to the extent these States have sufficient opportunity to adapt their policies. This assumes that such adjustments can be made without undue hardship or damage to other harmonization goals.

305. Political objections may arise based on issues of fairness and financing, as well as on the more fundamental debate as to whether the Community will emerge as a federalist entity. Under a Community model akin to federalism, one might justify transfer payments as the United States justifies aid to certain states. Under a model that assumes more sovereignty, the answer is less clear. On the one hand, Member States have agreed to adopt a system that brings in less revenue than under a destination principle, and therefore they should be compensated by those States whose revenues benefit from the change in policy. On the other hand, these states are sovereign and made their choice freely; any negative consequences should belong to them only. In light of these conflicting arguments, the temporary nature of the transfer system may help overcome objections by those who view the Community as a group of sovereign states rather than as a federalist entity. See BARRY

The main virtue of direct relief is that it dovetails more neatly with a purist theory of the Single Market. It solves the lost revenue problem while, from the viewpoint of the consumer, achieving the ideals of equal tax treatment, no risk of market distortion, and simplified law. In the case of transfer payments, it can be accomplished without creating a bureaucracy. The main drawback of direct intervention in any form is that it will remain politically controversial among Member States that resist any increased Community responsibility or that wish to retain greater autonomy and discretion.

## 2. *High Unified VAT Rate*

Revenue losses can be avoided altogether under the origin principle if the Community adopts a unified rate structure that is revenue neutral or produces a net revenue increase for all Member States as measured by receipts under the destination principle against receipts under the origin principle.

The advantage of such a system is that it results in a more harmonized VAT system. The main drawback to such a proposal is that it may have recessionary effects. This is especially problematic for those Member States that would have to raise their rates highest to compensate for revenue loss caused by a trade deficit. A severe tax increase could further depress their economies. Offsetting these increases in VAT by adjustments in other systems may not be feasible or may be counterproductive, given that the magnitude of the required adjustments would probably introduce an unacceptable level of variation in other policies.

A higher unified rate should only be used to offset the revenue loss of Member States to the extent it does not cause unacceptable recessionary effects.

## C. *Concluding Remarks*

Because VAT involves a high degree of transactions among nationals in different Member States, and, generally, a large number of transactions in absolute terms, it makes economic sense not to sacrifice the goal of a harmonized VAT. If the Community is to further unify rates and adopt the origin principle, it is clear that the Commission must address the problems of revenue loss and economic side effects in order to obtain the support of Member States.

In order to obtain the greatest economic advantage of the VAT system, the Community should adopt a single rate. This rate should be calibrated to avoid revenue loss to the greatest extent possible, without causing severe recessionary effects. Member States that experience inflation or recession as a result of this harmonization should make offsetting adjustments on an individual basis. These adjustments should, to the greatest extent possible, be made to other policies or

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EICHENGREEN, THE POLITICAL ECONOMY OF FISCAL POLICY AFTER EMU 16-22 (Center for International and Development Economics Research Working Paper No. C92-004, 1992) (arguing that fiscal federalism is necessitated by Monetary Union in any case, but that the Community budget is currently too small to have sufficient redistributive capacity).

tax systems<sup>306</sup> in which variation does not increase transaction costs as dramatically as it does under the VAT.

Whether the Community should pursue an origin-based system is less clear. The lessons learned during the transitional regime will undoubtedly influence the outcome of this debate.<sup>307</sup> In order to solve revenue loss resulting from the adoption of the origin principle, a temporary transfer payment system should be considered that redistributes revenue from the revenue winners to the revenue losers. Also, to the extent it does not create unacceptable recession or inflation, some loss can be offset by calibrating the unified VAT rate to produce gains for those injured in the transition to the origin principle. Retention of derogations might be deemed insufficient to replace revenue loss caused by adoption of the origin principle.

One caveat to these conclusions arises if further VAT harmonization would cause irreparable economic damage or would interfere with Monetary Union. In the case of economic side effects, individual adjustments and Community intervention can hopefully mitigate any economic damage caused by harmonization. In the case of Monetary Union, the Community would risk losing the benefits of Monetary Union in order to obtain the advantages of a more harmonized VAT.<sup>308</sup> Hopefully, these goals will be viewed as complimentary and the Community will not be forced to choose one over the other. If a choice is required, the weight of economic analysis would probably favor permitting variation in the VAT in order to allow Member States greater flexibility to intervene in their own economies and to pursue the goal of Monetary Union.

## VII. CONCLUSION

The transitional VAT regime will be a period of scrutiny, experimentation, and debate within the Community. This debate will focus on whether steps should be taken to further narrow, unify, or broaden VAT rate bands. Debate will also continue over which derogations should be retained or abolished. Individual Member States may find it difficult to support policies that solve "theoretical" problems or reduce transaction costs for the Community as a whole, but reduce their ability to relieve their own economic difficulties.

The outcome of this debate will have effects far beyond tax policy. VAT arrangements implicate the ability of Member States to meet their obligations towards Monetary Union. Greater VAT harmonization and resolving the collat-

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306. For instance, utilizing excise rates as a means to mitigate economic problems caused by rate unification was considered for the January 1, 1993 harmonization. Cf. OECD, *supra* note 8, ¶ 5.39, at 94.

307. See generally Jenkins, *supra* note 3.

308. The Commission has estimated the benefits of EMU to include lower transaction costs for firms and consumers, amounting to approximately 0.4% of GNP; reduction of information costs and price discrimination between countries, amounting to approximately 0.3% of GNP; dynamic effects created by the foregoing factors and exchange rate stability encouraging trade and investment, amounting to 0.7% of GNP; and integration of financial markets and the 1992 program. See Hughes Hallet & Vines, *supra* note 280, at 35, for a summary.

eral problems it engenders may extend the reach of the Community further into Member States' domestic affairs. It may therefore tell us whether the Community will evolve into a federalist system.

Finally, the European debate will continue to serve as a case study for policymakers in the United States and other countries, and will, therefore, continue to play a role in our own debate over the introduction of a VAT.

VIII. APPENDICES

APPENDIX A

THRESHOLDS FOR ACQUISITIONS BY TAXABLE PERSONS NOT ENTITLED TO VAT DEDUCTIONS, NONTAXABLE LEGAL PERSONS AND FARMERS SUBJECT TO FLAT-RATE SCHEME

Member State	ECU	National currency	
Belgium	10,000	450,000	BEF
Denmark	10,000	80,000	DKK
France	10,000	70,000	FRF
Germany	12,255	25,000	DEM
Greece	10,000	2,500,000	GRD
Ireland	41,600	32,000	IEP
Italy	10,000	16,000,000	ITL
Luxembourg	10,000	400,000	LUF
The Netherlands	10,000	23,000	NLG
Portugal	10,000	1,800,000	PTE
Spain	10,000	1,299,800	ESP
United Kingdom	52,000	36,600	GBP

Source: COOPERS & LYBRAND, A GUIDE TO VAT IN THE EC 300 (1993). These figures are as of March 1993.

APPENDIX B

THRESHOLDS FOR DISTANCE SALES

Member State	ECU	National currency	
Belgium	35,000	1,500,000	BEF
Denmark	35,000	280,000	DKK
France	100,000	700,000	FRF
Germany	100,000	200,000	DEM
Greece	35,000	8,200,000	GRD
Ireland	35,000	27,000	IEP
Italy	35,000	54,000,000	ITL
Luxembourg	100,000	4,200,000	LUF
The Netherlands	100,000	230,000	NLG
Portugal	35,000	6,300,000	PTE
Spain	35,000	4,549,300	ESP
United Kingdom	100,000	70,000	GBP

Source: COOPERS & LYBRAND, A GUIDE TO VAT IN THE EC 299 (1993). These figures are as of March 1993.

APPENDIX C  
 VAT RATES IN THE MEMBER STATES

	reduced rates				standard rate	higher rate
Belgium	0%	1%	6%	12%	19.5%	
Denmark			—		25%	
France	2.1%	5.5%			18.6%	
Germany	7%				15%	
Greece	4%	8%			18%	
Ireland	0%	2.5%	12.5%		21%	
Italy	4%	9%	12%	19%		
Luxembourg	3%	6%	12%		15%	
The Netherlands	6%				17.5%	
Portugal	5%				16%	30%
Spain	3%	6%			15%	
United Kingdom	0%				17.5%	

SOURCE: COOPERS & LYHAND, A GUIDE TO VAT IN THE EC 301 (1993). Rates are as of March 1993. Rates for Ireland have been updated.

APPENDIX D

THRESHOLDS FOR SMALL UNDERTAKINGS

Member State	Turnover in national currency		
Belgium	225,001	BEF	
Denmark	10,000	DKK	
France	70,000	FRF	(previous year)
	100,000	FRF	(current year)
Germany	25,000	DEM	(previous year)
	100,000	DEM*	(current year)
Greece	1,500,000	GRD	
	500,000	GRD	(services)
Ireland	40,000	IEP	(goods)
	20,000	IEP	(services)
Italy**	360,000,000	ITL	(services)
	1,000,000,000	ITL	(supplies)
Luxembourg	400,000	LUF	
Netherlands	4,150	NLG	
Portugal	1,200,000	PTE	(general)
	7,500,000	PTE	(domestic retail business)
Spain	50,000,000	ESP	(This threshold applies to manufacturing and services that qualify for flow-through method of accounting for personal income tax purposes; retailers are covered by a separate regime not covered here.)
United Kingdom	45,000	GBP	

\*Capital gains and some exempt sales excluded.

\*\*The small undertaking threshold in Italy only applies to allow a deferred payment of tax. Registration is still required.

SOURCE: COOPERS & LYBRAND, A GUIDE TO VAT IN THE EC, (1993) (from country chapters). The threshold for the United Kingdom has been updated as of December 1993. The other Member States are expected to raise their thresholds to the British standard. See footnote 57. The threshold for Ireland has been updated as of February 1994. *Irish Finance Minister Announces 1994 Budget*, 8 TAX NOTES INT'L 491, 493 (1994). All other figures contained in the table are as of March 1993.