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VAT on Intra-Community Trade and Bilateral

1. Introduction

According to the basic principle of the EU VAT Directive, the common EU VAT regime should ideally be neutral concerning the origin of goods and their stage of production or distribution, so that a single market which guarantees fair competition can be realised. At the same time a business in the EU which has a full right to deduct should be unaffected by the taxation of intra-EU trade, and would apply the same principle to cross-border purchases as it does to domestic ones, and pay the VAT due to its supplier and reclaim this as input tax on its VAT return.

Despite the introduction of the single market and the abolition of border controls in 1993, the destination principle still applies for the cross-border trade between firms in the EU, which are taxed with the zero-rate.[1] Since 1993 the member states must monitor the proper rebate of VAT credits for intra-EU supplies to and the proper payment of VAT on intra-EU acquisitions from other members by checking the books of registered enterprises.[2] Apart from the compliance asymmetry – the different VAT treatment of domestic and cross-border supplies – which cause non-symmetric compliance costs, the prevailing transitional VAT system has been criticised since the

* reason, such a transitional VAT system was then implemented by the Directives 91/680/EEC and 92/77/EEC. Yet the origin principle applies to the direct imports of households, although for some specific cases (including household purchase of cars) the destination principle still prevails. In addition an EU-wide minimum VAT standard rate of 15% was introduced.

[2] In this context VAT identification numbers were introduced to identify registered business from other member countries, and firms were obliged to provide detailed information on the intra-EU trade under the VAT Information Exchange System and Intrastat system.

Commission's reform model is additionally equipped with the internal correction of input-tax gap between the company that made the cross-border acquisition and the tax authority within the same country, which is caused by the difference between the national and the common EU VAT rates. This extra feature not only compensates the weakness of the VIVAT regarding the auditing problems of importers' invoices mentioned above but also makes the input-tax reimbursement possible according to the VAT rate and the deduction rules of destination country.[5]

This study attempts to put this proposal into perspective by linking it to the overall aims of value-added taxation in Europe and by comparing it to other alternative mechanisms to tax intra-Community trade as described in the literature. In particular this study focuses on the issues of bilateral revenue VAT clearing between EU member states, which would take place on the basis of a micro-model of firms' trade declarations.[6]

The study is structured as follows. Following this introductory part, Section 2 illustrates, based on a simple two-country model endowed with a single firm and household, the scope of VAT revenue clearing caused by the introduction of the origin principle on the B2B intra-EU supplies under the additional consideration of different VAT regimes (including a full switch to the origin principle and VIVAT). Section 3 describes the novel and distinct features of the European Commission's latest reform proposal in the same model framework and examines its advantages and shortcomings compared to the current transitional system and other previous VAT reform proposals. The final section summarises the major findings and concludes.

2. REVENUE CLEARING IN DIFFERENT EUROPEAN VAT SYSTEMS

A switch from the destination to the origin principle applied to the intra-EU supplies would cause VAT revenue changes in the individual EU countries. In order to correct such VAT revenue imbalances among the member states and to guarantee neutrality, a clearing mechanism is necessary. In the following it is assumed that there are two countries, *A* and *B*, and that each country has a (registered) company and a household. The intra-EU trade takes place between company *A* and company *B*, which consists of export volume of X_A (from *A* to *B*) and X_B (from *B* to *A*), while $X_A > X_B$. Then in country *B* the imported X_A is further sold to household *B* without any value added made by the domestic company *B*. The same process occurs with X_B in country *A*. The (standard) VAT rate imposed on these 'domestic' sales amounts to t_A in country *A* and t_B in country *B*, while $t_A > t_B > 0$.

[5] However, this reform approach would still provide an incentive to produce false import invoices through 'third countries' in order to qualify for a tax credit.

[6] According to the European Commission (2008), EU countries would become dependent on each other for around 30 billion euros of VAT revenue – approximately 10% of total receipts. The Netherlands, Germany, Belgium and Ireland would emerge as the largest net contributors to the clearing system. For the bilateral micro-clearing, there are three options for gathering such microeconomic data: collection by means of (i) the normal VAT declaration, (ii) a monthly recapitulative statement with global amounts for customer/supplier, and (iii) a monthly recapitulative statement at invoice level by suppliers and purchasers. The Commission prefers the second option.

FIGURE 1: INTRA-EU TRADE AND DESTINATION PRINCIPLE

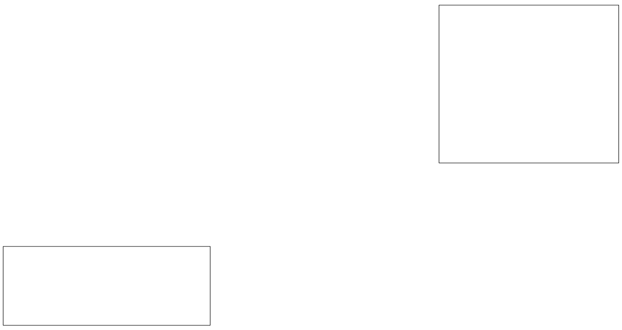
As illustrated in Figure 1, the B2B cross-border supplies are tax free in the present transitional regime. Moreover, in country *A* the final consumption of the imported goods from country *B* (X_B) bears the VAT burden with an own tax rate of *A* (t_A).

In a similar way one can also yield for government *B*

$$T_{B,ORI} = t_B{\cdot}X_A - (t_A{\cdot}X_A - t_B{\cdot}X_B) = T_{B,DES} - (t_A{\cdot}X_A - t_B{\cdot}X_B) \quad (4)$$

Movement from the destination to the origin principle alters the level of VAT revenues of the individual countries *A* and *B*. Since $t_A{\cdot}X_A > t_B{\cdot}X_B$, a clearing of the total amount of $(t_A{\cdot}X_A - t_B{\cdot}X_B)$ should take place between government *A* and government *B* in order to safeguard the revenue neutrality.

FIGURE 2: INTRA-EU TRADE AND PURE ORIGIN PRINCIPLE



Under the VIVAT, a common EU VAT rate ($t^* > 0$) is imposed on the B2B cross-border supplies between country *A* and *B* based on the origin principle, while sales to domestic customers (i.e. household *A* and *B*) are subject to the national VAT rate (i.e. t_A and t_B). In this framework company *A* can claim, for example, EU VAT credits on intra-EU acquisition from company B ($t^*{\cdot}X_B$) from government *A*, while company *B* can claim $t^*{\cdot}X_A$ from government *B*.

Consequently, when the VIVAT is implemented, the total VAT revenue for government *A* reaches

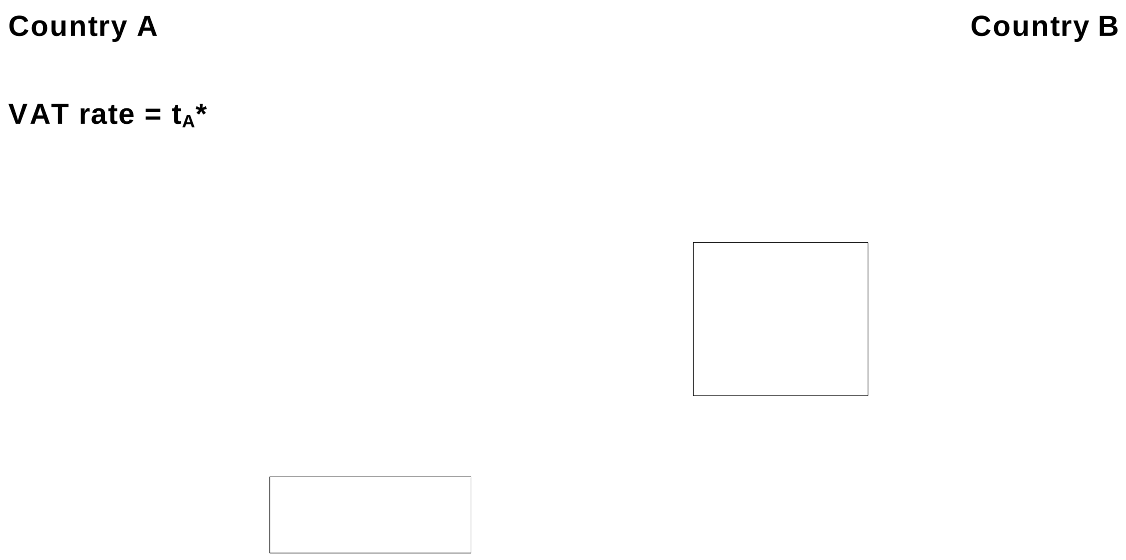
$$T_{A,INT} = t_A{\cdot}X_B + t^*{\cdot}(X_A - X_B) = T_{A,DES} + t^*{\cdot}(X_A - X_B) \quad (5)$$

while for government *B* the following applies:

$$T_{B,INT} = t_B{\cdot}X_A - t^*{\cdot}(X_A - X_B) = T_{B,DES} - t^*{\cdot}(X_A - X_B) \quad (6)$$

As expressed by equation *(5)* and *(6)*, the introduction VIVAT should also be accompanied by a clearing system in which the total sum of $t^*\cdot(X_A - X_B)$ would be transferred from government *A* to government *B*. In the context of such a cross-border fiscal transfer, revenue neutrality is ensured for both countries (see Figure 3).

FIGURE 3: INTRA-EU TRADE AND VIVAT



3. EUROPEAN COMMISSION'S VAT REFORM PROPOSAL WITH A BILATERAL CLEARING

In the following the major features of the European Commission's VAT reform model are introduced in more detail based on the same two-country model framework. The *current*, *transitional* VAT system remains basically applicable except where specified differently below. Company *A* (or company *B*) making an intra-EU supply charges, at a common rate (t^*) of 15%, VAT to its counterpart in another EU country. As is the case in most member states the standard VAT rate *tA* and *tB* are assumed to be larger than t^*. Therefore

$$tA > tB > t^* \text{ where } t^* > 0 \qquad (7)$$

Yet, in order to guarantee the neutrality of the system the purchasing company declares, in cases where the country is not entitled to deduct the VAT in full, an intra-EU acquisition in the country of arrival (destination) and accounts for the VAT difference that occurs, either positive or negative, between t^* charged on the operation and the domestic rate applicable in that country. In this context a type of (internal) input tax clearing takes place between the company and the government within the same country. In our example shown in Figure 4 such correction amounts to $(tA - t^*)\cdot XB$ for company *A*, while the sum reaches $(tB - t^*)\cdot XA$ for company *B*.

The purchasing company is now entitled to deduct the VAT it has paid to its supplier and the VAT it has accounted for because of the rate difference via the VAT return and according to the right-of-deduction rules of the country of arrival ("internal clearing"). As a consequence, company *A* can deduct $tA \cdot XB$ ($= t^*XB + (tA - t^*) \cdot XB$), while for company *B* the sum amounts to $tB \cdot XA$ (

In order to justify the effectiveness and superiority of the VAT reform recommendation the European Commission should thoroughly evaluate benefits and costs related to its introduction.[8] In particular the Commission should make it clear whether the potential to combat VAT fraud is worth the additional administrative costs and complications raised by the need for revenue clearing. The answer to this question will partly depend on the current extent of VAT fraud and on the extent to which this fraud can be eliminated by the proposal. In this context, it should be borne in mind that the recent Commission's VAT reform model primarily targets the prevention of carousel fraud. Yet there are other types of VAT fraud including (1) shadow economy fraud, (2) suppression fraud, (3) insolvency fraud and (4) bogus traders (Cnossen 2008a).[9]

prevailing deferred payment. Moreover, the optimal exploitation of current legal and administrative cooperation arrangements made among member countries appears to be more effective in handling the cross-border VAT evasion than the implementation of a new reform model with the exporter rating.

4. CONCLUSION

This study examines the EU's ongoing efforts aimed at searching for an efficient European VAT system that fits its single market concept. Unfortunately the previous attempts have been unable to achieve a satisfactory solution, which calls for a reopening of public discussions and policy actions on this matter in the EU. The European Commission's recent VAT reform model, applying the exporter pricing to the intra-EU supplies with a common EU minimum rate (15%), would compensate for the weakness of the deferred payment system which breaks the VAT chain and causes VAT fraud in a single market, and allows the different tax treatment of domestic and intra-EU supplies. The additional provision of

VAT fraud like shadow economy fraud, suppression fraud, insolvency fraud and bogus traders can hardly be tackled by this reform proposal.

The failure of VAT coordination in the EU mainly originates from the failure of a correct measurement of the volume of intra-EU exports and imports on the national level. For example, a smooth movement from destination to origin principle would be feasible if high quality intra-EU trade data were available in the EU. CertalT63.9o2bMEisty

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