VALUE ADDED TAX CELEBRATES 50 YEARS OF GLOBAL SUCCESS

Stephen Dale[1]

This was not the headline in Le Monde on the 10th of April 2004 but it could well have been. Here was a French invention celebrating its 50th birthday, having been "sold" into nearly 150 countries, with other major states looking at its implementation.

Instead the event was celebrated by the majority of the most important VAT experts in France, with a number of members of the French tax administration, in a quiet restaurant on the Isle de la Grande Jatte in Neuilly, near Paris. The candles were blown out and a toast was given to one of France's most important exports.

Maurice Lauré the founder of the modern VAT system would, I am sure, have been pleased to appreciate the impact that his work has had on businesses and governments around the world.

Why was it VAT?

The 10th April 1954[2], France adopted a system of general taxation of consumption called VAT, this tax replaced several older taxes, each having its own particularities and was to provide a solid base for financing the development of the French economy after the war, by, in particular, not taxing investment activities, and allowing France to compete better in the already nascent project of the Common Market. The period of gestation was nonetheless a long one and one can see as early as 1936/37 ideas being developed, many coming from within the

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2 Law N° 54.404 of 10th April 1954.

French tax administration[3], which would be found in the final VAT system adopted in 1954. What in particular is not generally known is that it was the CGT, "Confédération Générale du Travail" what was and remains a very powerful labour organisation (Trade Union), that produced a report at the end of 1946 and modified in 1947, in which it was effectively proposed a VAT, being a generally applied tax on the value added of all activities, with full deduction of input tax on all goods and services acquired by a business with the exception of VAT on assets[4].

Before 1954 there were essentially two major indirect taxes in France, (introduced in 1936 and modified considerably each year until 1954) the general tax, which taxed the majority of sales and importations, but only taxed producers (and not distributors) and a cascade type tax on services and certain types of sales. Several other smaller taxes existed at the same time on specific products such as meat, coal etc and other taxes introduced on transactions, in 1939 (but at very low rate, 1%), as well as a local tax on transactions, (with the addition of communal and departmental taxes) on goods and services introduced from 1941.

VAT was introduced on 10th April 1954 and was to be the sole tax with as generalised an application as possible with different rates applied to various categories of goods and services.

However, even at this date the VAT system was applied only down to the wholesale level, with full deduction of input tax credit, on all expenses and not just a deduction of the input tax on "physical" purchases, i.e. those goods that directly entered into the production of the good sold on at the next level.

For retail sales a local tax still remained up until 1968, with two rates of 2,75% and 8,5% and were effectively sales taxes. Services were also not generally within the VAT regime, unless the taxpayer opted to be so until 1st January 1968. From that date the full VAT system applied in France to the totality of the goods and services supplied at all stages of the production and distribution cycle.

It can be said nonetheless that the modern VAT system as we know it was introduced in France finally by 1968[5], but with its origins clearly from 1954 with the following characteristics:

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3 For example Julien Roger, where he proposed a tax on "gains" being the difference between the sales price and the purchase price of goods sold.

4 Jean-Jacques Philippe, Revue de Droit Fiscal N°7 – 2005

5 Law of 66-10 of 6th January 1966.

1. Payment of the tax by instalments;

2. Deduction of the tax paid at the previous stage

3. Based on invoices

4. Taxation at importation and

5. Exemption at exportation

6. Neutral for businesses in the intermediate stages of production and distribution.

At the same time the European Commission was looking at the issue of establishing an EC wide indirect tax and on the basis of the Neumark[6] report of 1962, VAT was "selected" as the choice of an EC wide indirect tax. The principle was confirmed in the first two VAT Directives[7] whereby the Member states at the time accepted to adopt VAT as the "unique" tax on turnover. One of the general principles stated at that time was one that provided that VAT should be applied to transactions between Member states and not applied to "importations" from other Member states. In other words to be able to treat a transaction from Paris to Bonn in the same manner as a transaction from Paris to Lyon.

The VAT system, as laid down in the two framework directives and substantially completed by the 6th Directive of May 1977[8], (this Directive was required to harmonise the tax bases as from the Council decision of 21 April 1970, the VAT bases were to be used to determine the levels of member states' financial contributions to the Communities' own resources) was destined to be as economically neutral as possible but leaving it up to Member states to determine how to apply the "rules" in practice. (Directives whilst having "direct effect"[9] need to be transposed, i.e. the Member states determine the means by which the Directive is given effect – Council regulations don't).

For the system to able to work there would have to be a reasonable approximation, if not harmonisation, of VAT rates and a system of compensation of the VAT receipts between the Member states. When the physical frontiers came down on 1st

6 Neumark Report (1962), Rapport du Comité Fiscal et Financier, Luxembourg, 1962.

7 First and second Council Directives of April 1967 – 67/227 and 67/228/EEC

8 Sixth VAT Directive 77/388.

9 Alitalia Conseil d'Etat 2 Feb 1989.

January 1993, there was a great hope expressed that at last the VAT system envisaged in 1967 would be able to be put into place.

The Commission's proposals to make progress towards the definitive system made in 1987 and then again in 1996 did not enjoy much success with the Member states, due to the possible effective loss of tax sovereignty and losses of budgetary receipts.

The arrangements put into place for 1993, the so-called transitional system, or as the Commission now calls them the "current system" clearly don't meet the objectives of the First and Second Directives as "exports" or intra-EU deliveries are exempted from tax and the "importations" or intra-EU acquisitions are still taxed under what is referred to as the "reverse-charge" mechanism in the hands of the acquirer.

As has been noted on a number of occasions and by the French "Conseil des Impôts" in its report in 2001[10] "the decision making progress within the EU in relation to VAT has become effectively blocked, most of the Commission's proposals have not been adopted, even when their contents have not had a direct relation with the taxation of intra-EU transactions. Only several technical texts have been, despite everything, adopted such as the special second-hand goods scheme, investment gold …"

The "definitive" system i.e. that as envisaged by the 1st and 2nd Directives, with taxation at the place of departure, is currently not making much progress as the Commission's various proposals have been either suspended or withdrawn. The Commission's approach has now been more to follow the approach adopted in the VAT strategy of June 2000[11] to simplify, modernise and reach a more uniform application of the tax and increase greater administrative cooperation between Member states. This strategy was reviewed and updated in the Commission's communication of 20th October 2003[12] and since 2000, 12 VAT proposals have been adopted by the Council.

These directives have been generally of a technical nature and whilst certain, eg invoicing, and e-commerce have provided simplifications for business, although for both of them there is considerably more work to do, it should nonetheless be stated that some of the directives adopted should enable significant progress to be made in the area of harmonisation of the legislations of the now 25 member states,

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10 Official Journal of the French Republic Page 1121 – 2001

11 COM (2000) 348 final

12 COM (2003) 614 final

for example Council Directive 2004/7 which allows the Commission to make proposals, on a unanimous vote of the VAT Committee to make proposals to the Council for the latter to make a regulation for the common application of the tax.

This is a curious legal instrument as it is made by virtue of articles 27 and 29 of the 6th Directive allowing the Council to make a regulation, which as we saw above is of direct effect, without the Member states being able to determine how it is to be applied.

The first such Council Regulation was adopted on 17th October 2005[13] with most provisions taking effect on 1 July 2006, apart from Article 13 which took effect on 1st January 2006.

In addition to the legislative progress that has been made since 1977, the European Court has, in fulfilling its role, interpreted the directives adding at each stage to the better understanding and harmonisation of the legislation.

However, as Jacques Poultre de Lamotte[14] said in a recent article, quoting from the report of the "Conseil des Impôts" in 2001, "the European Union decision making process regarding VAT is nowadays rather unsatisfactory, as the tax is essentially controlled by both the National and the Community judges, but is confronted by a rule making framework which is completely frozen".

The Commission nonetheless continues to make proposals, and can be cited here three of importance, the place of supply of services in B2B transactions[15], the special scheme for travel agents[16] and the scope of the reduced rates of tax[17].

These proposals have to date not made a lot of progress, but in the one on the place of supply of B2B services the concept of the "reverse-charge" is further extended, which as far as the principle of the simplification of application of the tax goes can not be criticised. However, the principle of the reverse-charge goes against one of the basic principles of the VAT system – the system of fractionated

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13 OJ L 288/1 – 29th October 2005.

14 Former head of the VAT Service in the "Direction de la Législation fiscale" in France. Article in Revue de Droit Fiscal N° 7 – 2005.

15 COM (2003) 822 final

16 COM (2002) 64

17 COM (2003) 397

payments[18].

The evolution of the European VAT system since 1954.

The increasing role of the National and European judge

The system of VAT has evolved under the pressure of, on the one hand the national and Community judges, and on the other a slow legislative process, the unanimity rule of the 25 member states being likely to make the progress even slower. The proposed Constitution, even if it were adopted in its current form, is not likely to change to any significant extent the process.

Member states have nonetheless seen their VAT systems profoundly changed under the influence of EU law, for example in France the particularities such as the “one month deferral system” whereby businesses could only reclaim VAT one month after the tax point, with certain exceptions, (this particular rule has its origins before the VAT system of Maurice Lauré in its introduction in 1948 for budgetary reasons) or the impact on the right to deduct certain input tax, see Sanofi case at the ECJ.[19]. This case had a marked impact on the administration of French VAT as the French government believed that by having obtained a derogation under article 27 of the Directive that effectively the Council of Ministers had validated the blocking of the recovery of VAT on certain types of subsistence expenses. After a number of further cases through the French courts,[20] the position has now been clarified to the extent that VAT on restaurant and entertainment costs can be reclaimed, subject to conditions, whereas that on accommodation (for staff) and travel cannot[21]. Member states can no longer be comforted by the fact that they have a derogation and assume that they are immune from attack; if the derogation given is itself not legal.

The case at the ECJ was, therefore, of vital importance in re-enforcing the supervisory role of the ECJ in that even the Council, acting on a proposal from the Commission following a request from a Member state, must ensure that the

18 France has recently, in article 94 of the amending Finance Law for 2005, extended the reverse charge mechanism to any non-resident making supplies in France. This provision is effective from 1st September 2006.

19 Sanofi Synthelabo ECJ – 177/99, ECJ – 181/99

20 FICIME – French Supreme Court – CE 5th April 2004 n°250356, 9° et 10° s-s

21 There remains an exception which is the recovery of 80% of the VAT on diesel fuel for cars.

derogation accorded is fully compatible with the underlying concepts of Community law.

It will be interesting to see, now that the first Council regulation has been issued[22] under the new article 29 procedure referred to above, how the Court will react if asked to review them, as the regulations are only supposed to determine the application of the VAT rules and not their interpretation. Clearly a very fine line exists between the two concepts.

The additional and increasing complexity of the tax

A number of concepts introduced by the judges have led to an ever increasing degree of complexity for businesses and administrations alike. A number of particular examples can be given:

1. Direct link between a supply and its consideration. [23]. As François Garcia has said in a recent article[24], “the concept of the direct link, which needs to be taken into account in determining if a transaction is within or outside of the scope of VAT, has in its effects the consequence of diminishing the scope of the tax. Businesses, however, have a different and more economic view of the application of the tax, leading to a more extensive appreciation of its application.” The question he asks is “which approach is the right one?”

2. Economic activity and the scope of the application of the tax, whereby certain activities are considered to be outside the scope of the tax as they are effectively considered to be the management of the assets of the entity as a “good father” might do, and as such are not “business” activities.[25]

3. The activities to be included or excluded from the pro-rata calculation[26]

This last issue, the items to be included or excluded from the pro-rata calculation, is an area of increasing complexity for businesses and administrations alike.

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22 OJ L 288/1 – 29th October 2005.

23 Apple and Pear Development Council – ECJ 102/86

24 François Garcia – Director of taxation and Customs at Renault, Revue de Droit Fiscal N° 7 – 2005

25 Polysar – ECJ 60/90 and Cibo Participations – ECJ 16/00

26 Régie Dauphinoise – ECJ 306/94, EDM – ECJ 77/01 and Satam – ECJ 333/91

Should the rule be an absolute one with no effective de-minimis limits or should businesses have to analyse all of their transactions to determine if they exceed certain thresholds?[27] In France the tax administration has been valiantly trying to produce an "Instruction" effectively their doctrine, to provide guidance to businesses and the administration for months; the formal instruction[28] was published finally on 10th January 2006 some 20 months after the EDM decision.

The tax seems to be going back to the system that existed in France pre-1954, where businesses had to effect a "physical" attribution of inputs to particular outputs. This is moving a long way from the simplistic tax VAT has always purported to be.

The Commission is aware of the issue and in particular in the area of financial services (another major area where simplification is required is that of public authorities which are moving more and more into the field of "commercial" activities), where they have indicated that a discussion paper would be produced before summer – 2005 (but due to pressures will be deferred until later in 2006), to outline the issues and propose a number of solutions to enable a certain level of simplicity to be re-instated into the VAT system. The paper will also address the non-neutral aspects of the tax – especially in "outsourcing" operations where the outsourcer has to charge VAT –to a business, which generally by the nature of the activities that it carries out, is not able to recover it. The VAT rules are here putting EU businesses at a competitive disadvantage by not allowing – except at increased cost – outsourcing in the financial sector. The Australian administration has found an apparent pragmatic solution to the issue whereby a recovery of the tax is allowed on the outsourcer's services to the extent that such services would not have attracted VAT if carried out within the company receiving such services, effectively the element representing the salary costs.

Financial services as noted are a particularly complex area. The definition of what is or is not a financial service is complex, (and what is or not a supply[29]). The definitions applied vary enormously between the 25 member states, with in addition certain countries applying the option to tax to certain services, where the option may be definitive or may be revoked after a certain period.[30] Services which could be opted no longer can be and vice-versa, which leads to uncertainty, has an effect on any VAT previously recovered (on application of article 20 of the 6th

27 Finance Law 2006, amending article 212 of Annex II of the French Tax Code

28 Instruction 3A-1-06 of 10th January 2006.

29 AG's opinion in the case of *Kretztechnik* ECJ - 465/03

30 Finance law 2005 in France – option can be revoked after 5 years.

Directive) and increases compliance costs. The Commission will also address some of these issues in its consultation document due this summer.

International transactions

In a recent report[31] the OECD has noted that the VAT systems have increased in their complexity essentially in the last twenty years or so, even though 50 years or more old, quite simply as a result of the ever increasing levels of international activity. This increase in international activity and the reluctance of Member states to move to a system of taxation in the country of origin, is one of the factors that has created this increased level of complexity, as can be seen by the number of pages of legislation both at national and EU levels, and for example in where in France the number of pages of VAT legislation has practically doubled since 1990.

This increased level of international business has also impacted on the levels of estimated fraud[32]. This is always a difficult exercise as it is effectively trying to put a number to an activity which by its nature is not visible. The European Court of Auditors has indicated that the level of VAT receipts of the 15 Member states is about €70 billion lower than they should be due to the levels of fraud. These are figures relating to 1997 so the estimate is that this number is far higher today. The Commission takes the issue very seriously and organised a conference on the matter, including one in June 2004 in Malta.

The Commission has been addressing the issue and one of the Regulations adopted in 2003 dealt specifically with the reinforcement of the levels of cooperation between Member states[33] to deal with fraud and tax evasion. The ECJ[34] has recently been asked to look at some of the "carousel" fraud type cases[35] and in its

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31 OECD report on the "Application of consumption taxes on international exchanges in services and immaterial goods " – June 2004

32 OJ of the EC 349 – 1998.

33 Council Regulation 1798/2003

34 Optigen Ltd, Fulcrum Electronics Ltd (in liquidation) and Bond House Systems Ltd v Commissioners of Customs and Excise, ECJ – 354/03, ECJ – 355/03 ECJ – 484/03

35 The Carousel fraud is not new, it has existed for many years in the Benelux countries, and operates as follows: Company A buys goods in a country where VAT is not charged on the purchase of goods destined to be delivered to another EU state (under application of article 16 of the 6th Directive). The goods are then sold to another company, B, in another EU state, who acquires them in that second member state. Company B then sells the goods to another company, C, in the same member state with VAT, but never pays the VAT to its country's tax administration. Company C tries to get the VAT back on the purchase from company B.

judgment, the Court has effectively indicated that without significant cooperation between Member states the types of fraud identified will be difficult to stop, as the end purchaser in the chain cannot be prevented from recovering the VAT charged by the supplier, who never accounts for it, provided that the transaction is a legitimate transaction and that the person reclaiming the tax was not aware that the transactions before the one in which he was implicated or further transactions down the "chain" were carried out only for fraudulent purposes – see here also the cases involving sales of drugs[36] . This seems to be the experience of the German administration which believes that significant amounts of VAT revenue are being lost by these types of fraud arrangements and as a consequence introduced legislation; whereby input tax is not deductible, if the recipient of the transaction knew or should have known that the supplier was not going to account for the tax on the supply to him!

The reason why this fraud works is because one of the basic principles of the 50 year old VAT system is for those types of transactions no longer applied, being the principle of the fractionated payments. The fraudsters have also of course determined that it is far easier to produce a VAT invoice with VAT on, which never gets declared than a bank note, and potentially far more valuable.

If VAT were, as envisaged in the First directive, applied to intra-EU sales, as if the sale were made within the same territory, the maximum loss to the governments of VAT on the transaction if the transactions were not declared would be limited to the VAT on the margin of the "fraudster" – far less of course than the VAT on his turnover.

This issue needs to be addressed as a matter of urgency, it undermines the VAT system, increases costs for legitimate businesses and administrations alike and could bring the existing VAT system, now 50 years old to an end.

The Rhineland Palatinate in Germany has come forward with some proposals, which are to be discussed at a major conference with Austria (which has the EU presidency for the first half of 2006) later this year, whereby "registered" businesses would be able to purchase from their suppliers VAT free goods and services with the tax only being due at the level of the retail stage.

In other words each registered business would have a certificate 'F' which after validation would allow his supplier to sell to him VAT free, goods and services acquired by the holder of the certificate. The idea has its attractions as it would stop the carousel type fraud, as no VAT would be charged by the supplier, but would be difficult to operate, in that suppliers would have to determine if the

36 ECJ – 294/82 and ECJ - 269/86

customer had a certificate 'F' or not, to charge VAT or not, to keep separate records and so on.

France has introduced, in article 94 of the amending Finance Law for 2005, an effective "reverse charge" provision to take effect from 1st September 2006 in relation to supplies made by non-established suppliers to VAT registered customers in France. The effect here is to ensure that VAT is no longer paid to non-residents who fail to account for such tax to the French Treasury – but will create, nonetheless, significant practical issues for businesses.

Conclusion

The VAT system in Europe and in over 150 countries is now 50 years old, it has evolved remarkably since its origins, but is now beginning to show signs of old age and is also not that well adapted to a global economy, although was ideal for France in the mid-fifties.

The Commission is doing its best to deal with the different issues outlined in this paper, for example the proposed directive on the place of taxation of B2B services[37] to bring the tax legislation more into line with business practice – at the expense again of limiting the effective control of the fractionated payment system.

There is clearly still a lot of work to do, the European Court will continue its work of attempting to ensure a correct interpretation of the texts to issues such as structures put into place to achieve a tax benefit, but with clear commercial motives, see for example the cases of Halifax and BUPA before the Court, or to determine what or is not a supply, see *Kretztechnik* – infra, and the Commission will pursue its four pronged strategy to help the tax evolve.

In order for this to happen and for the tax to really evolve, the Member states must accept to give up an even greater part of their tax sovereignty[38], difficult for those in particular those that by being part of the Euro zone have given up their monetary policy sovereignty. The Member states must therefore accept, even in the area of taxation to abandon the unanimity rule, as obtaining agreement on each minor change to the Directives, with 25 countries involved, has become an impossible task.

It is obviously not easy to predict, and it would be presumptuous of me to do so, what the VAT system might look like in the next 50 years. What can be said is that

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37 COM (2003) 822 final

38 Phillip Hardman lecture 1996 – given by Stephen Dale

in the next 50 years we will see an ever more rapid evolution of the VAT system, with new technology, tax engines and permanent tax audits (this was a suggestion made by Jean-Louis Journet – former head of the VAT section of the DLF[39]) allowing businesses and administrations to focus on core issues, reducing the scope for error and for fraud. With technology might we not see a rational for a revised sales type tax, whereby reconciliations on a real time basis would be made with sales made and the amounts of tax declared, with instantaneous refunds of tax credits? Or is Utopia still too far away?

39 Direction de la Législation fiscale – tax policy unit of the French tax administration.