Value Added Tax (VAT) on Online Sales in European Union

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The European Council of Ministers has adopted a proposal which, for the first time, will attempt to collect VAT on online sales by non-EU sellers of digitized goods (e.g., downloadable software, video and music) to EU consumers, starting in July 2003.

This is a significant development, but it is not necessarily inconsistent with trends in the United States. While Congress has extended through November 1, 2003 the Internet Tax Freedom Act's prohibitions on new state or local taxes on Internet access and on any multiple or discriminatory taxes on e-commerce (see our Internet Alerts of October 26 and November 20, 2001), some U.S. states are increasing their efforts to collect existing sales taxes on online sales (see our Internet Alert of June 26, 2001).

VAT is a tax that is imposed on sales of goods and services. The rate of VAT varies across the European Union (EU), although it is generally between 15-20%. The seller normally charges the VAT to the buyer, and the seller accounts for that VAT to the relevant EU tax authority. Since VAT is a sales based tax, its administration and collection is usually dependent upon where the seller (or occasionally, the buyer) in question is physically present, or, in other words, where the sale takes place.

A major difficulty created by e-commerce is that it creates a new method of selling. Products that traditionally had to be delivered in a physical medium (disc, tape or paper) can now be cost effectively supplied over much greater distances electronically. This has created a number of difficulties in the EU's collection of VAT and, until recently, no consensus on how to collect these taxes had emerged.

B2C Activity

A particular source of disagreement has been over the VAT treatment of downloadable electronic or digitalized services between suppliers and individual customers, and in particular EU customers purchasing from non-EU suppliers. While EU companies have to pay their domestic rate of VAT on downloadable electronic services, non-EU (most notably U.S.) companies currently pay no VAT or sales tax, enabling them to provide cheaper services to customers than their EU competitors.

The European Commission's plan is to make non-EU suppliers of digitalized services collect VAT from EU private individuals. As originally proposed in June 1999, non-EU suppliers of digitalized services to EU private individuals would have to register for VAT in an EU Member State of their choice and to account for VAT on their sales at the applicable rate in that Member State. The perceived disadvantage of this proposal (which was rejected) was that non-EU suppliers would probably register for VAT in Luxembourg, which has the lowest standard rate of VAT in the EU (15%), and that no VAT revenue would flow to the countries with higher rates.

In April 2001, a proposal was made (termed "the Swedish proposal") that, while non-EU suppliers of digitalized services were to register for VAT in only one country of choice, suppliers would have to account for VAT on their sales according to the rate applicable in each of the EU Member States where their EU customers were resident. Therefore, for example, a US supplier of music downloads could register for VAT in Spain, but it would then have to account for VAT at a rate of 19.6% on sales to French customers, 17.5% on sales to UK customers and so on. The revenue would then be redistributed by the Spanish authorities to the relevant tax authorities in other EU Member States through a clearing house system.

The Swedish proposal is now set to become law within the EU. It is possible, however, that a de minimis registration level will be adopted, such that non-EU suppliers will not need to register for VAT in any EU Member State where their annual sales to EU customers are less than $87,400 (based on the current Euro/$ exchange rate). A press release issued by the Council of Economics and Finance Ministers on February 12, 2002 confirmed that EU Member States will have until July 1, 2003 to implement the new rules.

There has been some strong reaction within the United States to the EU proposals. The Information Technology Association of America (the ITAA), a well known US lobby group, has issued a press release suggesting that the new rules could slow the speed of Internet transactions. The press release also quoted ITAA president Harris N. Miller as saying that:

> "There is the risk that the EU may prescribe rules of compliance that, in effect, will close the European market to U.S. and other non-EU businesses for certain transactions."

B2B Activity

The VAT position with respect to business-to-business transactions (which the EU estimates accounts for at least 90% of the online market) between non-EU suppliers and EU business customers is clearer. Under the "reverse charge" procedure, a business customer receiving a supply of services from a non-EU supplier is generally treated as having made the supply to themselves, and they must account for the VAT on the supply in their own EU Member State (although they should get full input tax recovery). In other words, the non-EU supplier is not required to pay VAT on such sales.

In order to avoid the need for VAT registration in the EU as described above in relation to B2C activities, it will be necessary for the non-EU supplier to verify that the business recipient is a taxable person with the necessary status, and that the business recipient has received the services for consumption in their own EU Member State. All possible diligence must be exercised by the non-EU supplier in verifying the status of his customer. However, the EU envisages that an online method of verification should be made available for these purposes. On this basis, a non-EU supplier supplying only B2B customers within the EU should not be required to register for VAT in any EU Member State.

EU Member States

Non-EU suppliers of digitized services will be caught by the new rules if they make B2C supplies to consumers anywhere in the EU.

Currently, the Member States of the EU are as follows: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

The following States have indicated a desire to join the EU: Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, the Slovak Republic, Slovenia, and Turkey. Therefore, U.S. suppliers of digitized services may also be caught by the new rules in these additional countries in the future, as they become members of the EU.

Obviously, the details of the EU's new VAT collection scheme will become clearer in the coming months. However, U.S. e-retailers need to begin planning today for the significant economic impact that will occur with respect to their digitized sales to EU consumers, once VAT begins to be charged in mid-2003.

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