

An Overview of Consumption Tax Implications on Sale of Digital Downloads in the European Union

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ABSTRACT This article gives an overview of the current VAT treatment in the EU of digital downloads of films, audio, text, and other media provided by established as well as non-established companies to taxable and non-taxable persons. Four specific issues are discussed; the classification of electronically supplied services, an overview of who may be regarded as a taxable person, the definition of a fixed establishment and where electronically supplied services are deemed to be supplied. Proposed changes of the VAT treatment for established companies and their possible effects are also evaluated in relation to the last issue.

KEY WORDS: consumption taxation, VAT, digital services, electronically supplied services, fixed establishment, content downloads

The possibilities of downloading music, films, text and other information using a computer or a mobile phone are many times greater than could even be imagined as little as ten years ago. Offering these types of services for consideration commonly give rise to consumption taxation depending on the applicable tax system. If a consumption tax rate applies to the supply, it affects the price unless the purchaser has the right to deduct it, which normally only applies to taxable persons. A taxable person is commonly a business carrying on economic activity on an independent basis. The burden of the tax is carried by the final consumer. The applicable VAT rate on sales to the final consumers can then affect the supplying companies' competitiveness.

A common system of value added tax (VAT) exists within the European Union (EU), where the tax base is harmonised but the collection and administration of the tax is a matter for the national authorities in each Member State. The Member States are obliged to follow EC law and to ensure a correct application on a national level. (Art. 10 EC) The harmonisation of VAT in EU has its base in Art. 93 EC

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and several directives since the first in 1967 have been adopted. Since 1 January 2007 the known and central sixth VAT directive, in consolidated form, is replaced by directive 2006/112/EEC on the common system of value added tax (RVD), providing new wording and structure. Even though a harmonised tax base for VAT purposes exists within EU, differences between the Member States exist due to possibilities to do exemptions according to the EC directives and also the treaties of accession. There are different exemptions covering e.g. cultural activities, which affects both if these supplies are taxable or not (Annex X RVD) and the applicable VAT rate. (Annex III RVD) The exemption should be interpreted in a strict manner. Unacceptable extensions may result in an infringement procedure as e.g. one against Sweden for applying a reduced rate of 6 per cent VAT to audio books instead of the standard rate of 25 per cent. (IP/07/402) Due to the differentiation between the different Member States, it is advisable to thoroughly examine the exact rules of the Member State before e.g. deciding upon an establishment in a country.

To know which tax rate that applies to a supply, several questions need to be answered. The first one is; who is the supplier and the purchaser? Are they taxable persons or not and where are they established or resident? What is being supplied and how is it classified in the applicable tax legislation? Where is the supply deemed to be made due to this classification? Depending on the answers to the different questions, the tax consequences for tax liable companies differ and different VAT rates may apply to their transactions. The standard rate of VAT within EU varies between the different Member States. Denmark and Sweden have the highest standard rates of 25 per cent. Cyprus and Luxembourg have the lowest standard rates of 15 per cent. Considering that there are also reduced rates and super reduced rates *and* zero-rated supplies; the rates may differ between zero and 25 per cent, dependent on how the services are classified both for deciding the place of supply and the applicable VAT rate. The standard rate in each Member State is normally applied to downloadable media content, *if* these are classified as electronically supplied services. The classification depends partly on the human intervention in the supply. If these supplies instead are classified as e.g. cultural services, reduced tax rates may apply, again differing between the Member States. Supplies of services by authors, artists and performers are e.g. taxed with a 7 per cent reduced rate in Poland and a 5 per cent reduced rate in the Czech Republic.

Company A, established in a state outside EU is subject to the laws of that state. If it sells services to customers in EU, it may instead be tax liable for supplies made to these customers in an EU-state. Company B is established in an EU-state selling similar services as company A to customers in EU. Do the same VAT rates apply?

To find the main place of business of the supplier and purchaser may not be difficult, but finding out if it has a permanent establishment in another state than that of the main place of business, according to the

applicable consumption tax legislation, may be more challenging. Within EU it is the Court of Justice of the European Communities (ECJ) who ultimately decides the definition and scope of a permanent establishment, or fixed establishment, using the equivalent VAT terminology. The definition found in case law from the ECJ differs from the definition of permanent establishment for direct tax purposes.

Since the VAT system within EU is based upon principles of neutrality, double taxation, non-taxation and distortions of competition are undesired consequences within the system. Issues related to taxation of e-commerce have been discussed a lot in literature and is still discussed frequently. (See e.g. Cigler et.al. 1996 and Westberg, 2002, Kogels 2006 and Westin 2007) It is important to continue the discussion related to these issues, since society and means of trading is evolving rapidly. In January 2005 there were almost 40 million broadband connections in the EU (then 25 Member States), corresponding to a penetration rate in terms of population of 10% in the EU (based on the first 15 Member States) and of 8.6% in the EU (with 25 Member States, Bulgaria and Romania, not enclosed). (Commission, 2005) The use of broadband is rising rapidly in EU, increasing the possibilities of downloading media content in cross-border situations. It is also closely monitored by the Commission and public authorities on national level, supporting the broadband development in regions that are less developed. This article brings up some of the VAT issues related to certain digital supplies.

AIMS AND SOME METHODOLOGICAL NOTES

The aim of this article is to describe the VAT treatment of certain digital services, as defined in the following section, from a legal perspective, and discuss possible effects on companies established within EU compared to companies established outside EU. This covers four specific issues within the EC VAT:

1. The classification of certain electronically supplied services related to media services.
2. The definition of taxable person.
3. The definition of fixed establishment in the EC VAT with a view of the definition of permanent establishment in the OECD Model Tax Convention.
4. Deciding the place of supply for certain electronically supplied services. Current proposals in the EC VAT of changes in the taxation of services on the internal market are also discussed related to the possible effects that they might have on established as well as non-established companies. (COM (2003) 822 final and COM (2005) 334 final)

The rules for deciding the place of supply of goods differ from the rules for deciding the place of supply of services and are kept outside the scope of this article, to avoid broadening the discussion even further. The discussion on whether digital supplies should be treated as goods or not is also kept outside the scope of the article, since these supplies should be treated as services within EU. (COM (1998) 374 final, p. 5) There are, however, few examples where the classification of goods and services are discussed related to applicable VAT rate for comparative reasons. Thus, this article focuses on direct e-commerce or electronic commerce involving digital deliveries and not indirect e-commerce where the goods or services is ordered on-line, but delivered off-line. The later may also be referred to as e-commerce involving non-digital delivery. (Hinnekens 2002, p. 65)

Media services cover a wide range of both traditional goods and services, for VAT purposes affecting electronically supplied services, traditional supplies of goods, telecommunication services as well as radio and television broadcasting services. Media services in this particular article cover only a limited part of electronically supplied services and not the full range of goods and services normally covered by media services. Questions on how to treat media services when bundled or composite is an important issue, not least considering that technical possibilities simplifies interaction between previously traditionally separated services. (See e.g. Liebman and Rouselle 2006) This issue is, however, left outside the scope of this article, since it then also should address telecommunication services and radio and television broadcasting services.

This article does not give a full overview of the application on national level in the Member States but addresses the VAT treatment of certain digital supplies on an EU level. According to the principle of supremacy EC law prevails over competing national law in the Member States. (See e.g. cases 26/62, 6/64 and 11/70) The ECJ has the sole right to interpret EC law and has through several cases established principles to ensure the effects of EC law on national level. (See e.g. cases 14/83, C-6 & 9/90 and C-224/01) The effects of EC law on actors on the European market are fundamental and an analysis and discussion of EC law is vital for the national application of VAT.

DEFINITION OF CERTAIN DIGITAL SERVICES

Electronically supplied services were introduced in May 2002 by the adoption of a temporary directive, also providing a special scheme for companies not established in an EU-state. (Dir. 2002/38/EC) The rules prior to the 2002 directive were not inline with the principle of taxing services at the place of consumption when consumed within EU causing distortions in competition between companies established in an EU-state and those not established in an EU-state. (COM(2000) 349 final, p. 3)

Electronically supplied services were not defined in general terms in the 2002 directive but the Council Regulation of 17 October 2005 (Reg 2005) gives a general definition where electronically supplied services include “...services which are delivered over the Internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, and in the absence of information technology is impossible to ensure”. (Art. 11 Reg 2005) The Regulation is directly applicable in all Member States and a definition of electronically supplied services is therefore not found in art. 56 (1) (k) RVD, (previously Art. 9 (2) (e) in the sixth directive). Examples of electronically supplied services are provided in Annex II RVD, originating from the directive of 2002:

1. *Website supply, web-hosting, distance maintenance of programmes and equipment.*
2. *Supply of software and updating thereof.*
3. *Supply of images, text and information and making available of databases.*
4. *Supply of music, films and games, including games of chance and gambling games, and of political, cultural, artistic, sporting, scientific and entertainment broadcasts and events.*
5. *Supply of distance teaching.*

If services fall within the scope of electronically supplied services the tax consequences for the supplying companies are different compared to if the services would fall under the scope of other supplies of services or even supplies of goods. If a book is delivered by traditional post, it is regarded as a supply of goods and taxed in accordance with the rules covering supply of goods. The rules differs both when it comes to deciding the place of supply as well as the applicable VAT rate. If a book is deemed to be supplied in the UK the supply is zero rated and if deemed to be supplied in Sweden the applicable VAT rate is 6 per cent. If the same content is downloaded in the form of an e-book and the supply is deemed to be made in the UK, the standard VAT rate of 17,5 per cent is applicable. The similar example, supplied in Sweden would be taxed with 25 per cent.

If the purchaser is another taxable person, the competitive effects for the supplying company are less affected by the differences between applicable VAT rates. There is also a reverse charge mechanism within the EC VAT, which makes the purchaser tax liable for the transaction, instead of the supplier. (Art. 196 RVD) If the purchaser is a non-taxable person, the differences in the VAT rates within EU affect the supplying companies' competitiveness to a larger extent. Especially when prices are easy to compare and the location of the supplier and purchaser are less relevant, which in many cases applies to supplies of electronically supplied services. Differences also exist between different types of services and how the place of supply of these services is decided. Services

classified as electronically supplied services are also covered by a special scheme for companies not established in an EU-state.

Focus in this article is on certain digital services, part of the electronically supplied services listed above, specifically, indent 3 and 4. These services cover a wide range of services which can be downloaded both by using a computer and a mobile phone. They may be referred to as media services with a narrow interpretation, but are commonly referred to as electronically supplied services in this article. Services covered are e.g. downloading and accessing music, films, e-books, software, information and games.

The Regulation of 2005 gives, amongst other issues, further guidance of supplies falling under the scope of media services as found in the third and fourth indent. The Regulation is built upon guidelines given by the VAT Committee, which is an EU advisory committee consisting of representatives from the Member States and the Commission (Art. 398 RVD). Further, the Regulation is limited to the specific circumstances brought up and should be applied restrictively to other cases. (Reg. 2005, preamble, para. 3) The following services are listed in Reg 2005, adding several types of services to indent three and four of Annex II:

- (3) *Supply of images, text and information, and making databases available.*
 - a) *Accessing or downloading desktop themes*
 - b) *Accessing or downloading photographic or pictorial images or screensavers*
 - c) *The digitised content of books and other electronic publications*
 - d) *Subscription to online newspapers and journals*
 - e) *Web logs and website statistics*
 - f) *Online news, traffic information and weather reports*
 - g) *Online information generated automatically by software from specific data input by the customer, such as legal and financial data, (in particular such as data as continually updated stock market data, in real time)*
 - h) *The provision of advertising space including banner ads on a website/web page*
 - i) *Use of search engines and Internet directories.*
- (4) *Supply of music, films and games, including games of chance and gambling games, and of political, cultural, artistic, sporting, scientific and entertainment broadcasts and events.*
 - a) *Accessing or downloading of music on to computers and mobile phones*
 - b) *Accessing or downloading jingles, excerpts, ring tones, or other sounds*
 - c) *Accessing or downloading films*
 - d) *Downloading of music on to computers and mobile phones*

- e) *Accessing automated online games which are dependent on the Internet, or other similar electronic networks, where players are geographically remote from one another.*

It is positive with further exemplification of services falling under the scope of the third and fourth indent, as given by the Regulation. Even so, some questions on the scope of these indents could be raised. The guidelines from the VAT Committee serving as a base for the Regulation of 2005, where given in January 2003. (VAT Com 2003) There are no substantial differences between the guidelines and the Regulation for the interpretation of electronically supplied services. This may be a sign of difficulties in deciding how to deal with supplies of these kinds, or that there is no further need of guidance. Considering the rapid development of new types of services the latter interpretation seems less likely.

Even so, it is interesting to notice that online information automatically generated from software, is an electronically supplied service of information even when covering legal or financial data, which otherwise are covered by other types of services in the EC VAT. A service containing legal advice is commonly a service covered by art. 56 (2) (c) RVD and financial services are covered by art. 56 (2) (e) RVD, if not exempted from VAT in accordance with art. 135 RVD. One difference between the services treated as electronically supplied services and legal and financial services is the involvement of human resources of some sort. This is an argument similar to the one also used by the Commission to differ cultural and similar services, e.g artistic, entertainment and sporting activities, which are taxed where they are performed, from similar services that can be supplied at a distance without human presence. (See COM (2005) 334 final, p. 12) This is also in line with the general definition of electronically supplied services as found in Reg 2005 (cit. above). What types of services could then fall within this general definition of electronically supplied services? As technology is evolving and new services are developed – is this definition flexible enough to be functioning in a long term perspective? Is there a risk of differing interpretations in the Member States? As patterns in trade may change and different media services become more and more accepted in a digital form by consumers – can different tax rates still be justified?

Another interesting issue is that advertising through banners and pop-ups on a web page fall under the scope of electronically supplied services, whereas other advertising services fall under the scope of art. 56 (2) (b) RVD. It is possible selling advertisements for use within computer games. The advertisements are specifically targeted dependent on the users movements within the game and on-line activity connected with the game. Computer games purchased traditionally in a store is classified as goods in accordance with art. 14 RVD, whereas electronically downloaded computer games fall under the scope of art. 24 RVD as a supply of service. The rules for deciding the place of supply is found in the previously mentioned art. 56 RVD. Would the

advertisements in these games be classified as advertising services or electronically supplied services, treated similar as banners and pop-ups? The answer to this is likely to be dependent on the degree of human intervention for supplying the advertisements.

We do know that some services explicitly listed in Reg 2005, shall *not* be treated as electronically supplied services. Some of the services listed in the regulation are listed below to give a picture of the scope of the regulation. (art. 12 Reg 2005)

- (1) *radio and television broadcasting services*
- (2) *telecommunication services,*
- (3) *services of professionals such as lawyers and financial consultants, who advice clients by e-mail*
- (4) *teaching services, where the course content is delivered by a teacher over the Internet or an electronic network*
- (5) *teaching services purely involving correspondence courses, such as postal courses*
- (6) *advertising services, in particular as in newspapers, on posters and on television*
- (7) *conventional auctioneers' services reliant on direct human intervention, irrespective of how bids are made*
- (8) *telephone services with a video component, otherwise known as videophone services*
- (9) *access to the Internet and World Wide Web*
- (10) *telephone services provided through the Internet*

Point 1 and 2 of the list above need perhaps no explanation since these are defined as specific types of services. (Art. 24 (2), 56 (1) (i)-(j) RVD) One may, however, note that services tend to be combined or bundled and this is likely to increase due to new technical possibilities. Difficulties in separating these supplies may then exceed. Points 3-7 are services relying on substantial human intervention and the Internet or electronic networks are only used as a means for communication and should thus not affect the classification of the services. (VAT Com 2003, pp. 10-11) Points 8-10 are further regarded as telecommunication services. (VAT Com 2003, p. 12)

Businesses, tax authorities and courts thus stand before rules classifying different supplies where the answer of what is an electronically supplied service is half-and-half given. We do know that certain supplies are not to be treated as electronically supplied services, but further clarification is necessary. Is it possible developing a factor test, where a transaction fulfilling some factors is likely to be an electronically supplied service, or is it the purpose of the services that should be guiding? Within in EU, with the structure of national authorities administering the VAT, it is likely that different views of what should be covered by electronically supplied services develop. Companies would then be treated differently depending on where it

submits its tax returns, closely connected with issues of where companies are established and possibilities of fixed establishments in other countries. Risks of double taxation and non-taxation could then occur both within EU and in trade with countries outside EU. Tools for minimising these risks on an international level need to be developed. The rules must give clear guidance and at the same time have a high degree of flexibility to deal with the technological changes and developments. The Commission (EC) has issued a consultation paper on how to avoid double-taxation in individual cases. Such a procedure would involve a mutual agreement procedure followed by an arbitration procedure if the mutual agreement procedure fails. (COM, cons. paper, p. 10) Such a procedure could solve the problems in individual cases, but is likely not to enhance the foreseeability at large. Mutual agreements procedures are commonly not public.

Services falling under the scope of electronically supplied services are likely to have a small degree of, or no, human intervention, such as e.g. downloading video or audio through an automated process. Companies supplying these services need to be aware of differing views in states on how these services should be classified and differences in applicable rates. The systems of order, payment and delivery need to be able to deal with these differences calculating the correct VAT on each supply. In this process the location of the recipient and if he or she is a taxable person or not, need to be identified. There are clear risks of double taxation under the current system if the supplies are classified differently due to differing applications in the Member States. The main reason for this is differences in the level of harmonisation within EU and the possibilities for national authorities to give guidelines on how different supplies should be treated where EC guidelines do not exist.

TAXABLE PERSON OR CONSUMER

The EC VAT does not define a consumer, but sets up criteria for who may be regarded as a taxable person. A taxable person is defined as “...*any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity*”. (Art. 9 RVD) The ECJ has in its case law clarified the scope of taxable person, as to cover preparatory acts and also goods not only used for the economic activity even if the proportion of business use is small. (See case 268/83, para. 23 and case C-97/90, para. 35) Where goods are also used for private purposes, a proportional deduction for VAT on expenses is allowed for the proportion to which the goods are used within the taxable person’s economic activity. (See case C-230/94, para. 38) This should also be compared with the opposite, where a taxable person purchases a capital item both used for business purposes and private purposes where he or she can retain it wholly as private assets. The item is then in its entirety kept outside the VAT system. (See case C-415/98, para. 34)

Economic activity is defined as “[a]ny activity of producers, traders or persons supplying services, including mining and agricultural activities and activities of the professions.” It further covers “[t]he exploitation of tangible or intangible property for the purposes of obtaining income therefrom on a continuing basis”. (Art. 9 RVD) Economic activity thereby covers a wide range of supplies of services and goods, comprising all stages of production, distribution and provision of services. The ECJ has expressed that exploitation refers to all transactions, irrespective of their legal form, as long as the other conditions of e.g. obtaining income therefrom on a continuing basis are upheld. (See case C-186/89, para. 18)

Holding companies are generally not seen as taxable persons if their sole purpose is to acquire holdings in other undertakings and they are not directly or indirectly involved in the management of those undertakings, without prejudice to its rights as a shareholder. (See case C-60/90, para. 17) Acquisition of financial holding like securities in other companies may constitute economic activity, but not where the only consideration for these transactions consists of a possible profit. Where activities of sales and purchases of securities go beyond the mere sale and acquisition, as when a person assembles and manages portfolios of transferable securities the conditions for an economic activity may be met. (See case C-8/03, paras. 41-44)

The degree of independency for the taxable person is not dependent on its legal personality, but aims at delimiting persons bound to an employer or any other legal ties creating a relationship similar to the one between an employer and employee. The working conditions, remuneration and the liability for the employer or carrying of a risk connected with the economic activity need to be considered. (See joined cases C-78/02-C-80/02 para. 35 and case C-210/04, para. 35)

A company supplying digital supplies on an international market thus need to consider the organisation of branches etc. If supplying services closely connected with e.g. financial holdings of different kinds a closer evaluation of economic activity and the degree of independency might be needed. The criterion of independency primarily aims at delimiting economic activity performed by employees from the scope of taxable persons. (See Ramsdahl Jensen 2004, pp. 270-271) Even so, case law from the ECJ show that the degree of independency also affects if a company has a fixed establishment or not, since the scope of VAT and the degree of independency affects if a direct link exists between the provided supply and the consideration from the purchaser. (See case C-210/04 paras. 32-35)

If an EU-resident downloads audio files from a web site based in the UK, for its private use the transaction is, under the current rules, taxed with the applicable rate in the UK. If the same EU-resident downloads photographs for use in a magazine, first the objective of the magazine needs to be considered. The purchase could then be made for the purpose of a taxable person and this would alter the place of the supply and thus affect the applicable VAT rate. The supplying company cannot know if

the pictures or the audio files are used for the purchaser's taxable activity or the private use, but need to focus on the information given by the purchaser as regards e.g. VAT number. Customers should have the possibility to enter information about their status in a comprehensible manner.

FIXED ESTABLISHMENT

A company supplying digital services does not need to rely upon traditional logistics in the same sense as a company supplying traditional goods. The technical standards and availability to networks is more important combined with when and how a company can have a fixed establishment that affects the taxation of the supplies. Within EU different rules apply to supplies of certain digital services depending on if the company is established within EU or not. There are also proposals on changing the consumption taxation of services for companies established within EU. These changes may well affect the competitive arena for both established and non-established companies.

Development in Case Law and Current Criteria

The general rule for deciding the place of supply of services is found in Art. 43 RVD whereby services are taxed where the supplier has established his business or where he has a fixed establishment from which the services are provided. There is no other definition of what a fixed establishment is. The Commission has discussed if there is a need to codify the meaning of fixed establishment, but is of the view that the present status is acceptable. (COM(2003) 822 final, p. 9) It is not the concept of permanent establishment as used in Double Tax Treaties and defined in art. 5 of the OECD Model Tax Convention on Income and Capital (OECD MTC) that is decisive for VAT purposes. (Case C-210/04, para. 39) A company can thus be deemed to have a permanent establishment for income tax purposes but not for VAT purposes.

Art. 43 RVD should be read in conjunction with arts. 2, 9 – 13 RVD. The first mentioned article gives the general rule for deciding the place of supply of services, whereby the later mentioned articles states which transactions that are subject to VAT and who may be regarded as a taxable person. This has been emphasised by the ECJ in many cases on a discussion of a direct link between the supply and the consideration and if there is a legal relationship or not between the provider and purchaser. (See e.g. case C-16/93, paras. 14-17)

The concept of fixed establishment as developed in case law from the ECJ, entails the criteria “...*the establishment must be of a certain minimum size and both human and technical resources necessary for the provision of the services are permanently present.*” (Case 168/84, para. 18) The ECJ has further held that the primary point of reference is where the supplier has established his business. If this does not lead to *rational*

results for tax purposes or leads to conflicts between Member States, a fixed establishment from where the services are supplied could be taken into account. (See case 168/84, para. 17) The degree on independency of the fixed establishment also needs to be considered. (See case C-260/95, paras. 25-28) If a subsidiary or a branch has its own legal personality or not, is not decisive, but the *independency* of the economic activity carried out by the subsidiary or branch need to be evaluated. In the evaluation of the independency of a branch or subsidiary the risks taken by it for its own business should be taken into account. (See case C-210/04, paras. 35-37) There must also be a framework for the services to be supplied on an independent basis, including where the management decisions are taken. (See case C-390/96, para. 19)

Gaming machines on board ferries does not constitute a fixed establishment according to the ECJ, especially since VAT can be appropriately charged at the place where the supplying company has established its business. (Case 168/84, para. 18) A later case, also concerning gaming machines, upheld the previous case law on fixed establishment, but altering the classification of the services as falling under the scope of art. 9(2)(c) in the sixth directive, now Art. 52 RVD. (See case C-452/03, paras. 31-33) The place of supply is thereby altered from the place where the supplier is established to the place where the services are physically carried out.

Restaurant services on board ferries where neither deemed to constitute a fixed establishment by the ECJ. The main reasons for this decision was that the place where the supplier had established his business gave an appropriate place for tax purposes and the ECJ also found it difficult to see that restaurant services on board ferries could fulfil the criteria of a fixed establishment especially considering that this does not apply where the place of establishment of the business leads to rational results. (see case C-231/94, para. 18) Cases concerning leasing of cars and yachts, points out that forms of transports easily move cross borders which makes it difficult to determining the place of utilisation. The appropriate point of reference for tax purposes has instead been the place where the supplier has established his business. (See case 51/88, para. 12 and 18, case C-190/95, paras. 12-14)

For companies supplying electronically supplied services several interesting issues arise. The company must consider the tax consequences dependent on where it is established and the type of commerce that is performed through that establishment. One must also consider what types of services that are offered from the establishment. Online games fall under the scope of electronically supplied services and taxed where the supplier or recipient is established, whereas services supplied through gaming machines are taxed where they are physically carried out. Are the services exchangeable? Online games can be supplied on a distance while services through gaming machines are supplied at the place where the machine is located. Both give the recipient amusement and in that sense the services may be seen as exchangeable,

but not in the sense of being able to replace each other, especially considering the convenience of being able to use an on-line game directly from where you are located.

For VAT purposes a server is not likely to fulfil the criteria set out by the ECJ. Partly due to the lack of human involvement, but not least due to the criteria mentioned several times by the ECJ of reaching a rational tax result. (See e.g. cases 168/84, C-231/94 and C-190/95) This argument could, however also be used in the opposite direction where a rational tax result could be reached if a server is considered to be a fixed establishment. One could, however, also argue that the RAL case classifying services supplied by gaming machines as services to be supplied where they are physically carried out may open up for a widening of fixed establishment for VAT purposes to be more similar to the permanent establishment for income tax purposes. No signs from the ECJ has however been shown towards this direction in later cases. (See e.g. case C-210/04)

Electronically supplied services easily cross borders and technical equipment is not difficult to move. Since the ECJ has not opened up for disregarding the criteria of human resources for having a fixed establishment, servers are currently not likely to create a fixed establishment for VAT purposes. Re-classification as in the RAL-case is more likely.

Companies that are not established in an EU-state and has its primary point of reference in a low tax state or other states, are under the risk of having transactions to be taxed more than once, selling electronically supplied services to non-taxable persons resident in an EU-state, if the legislation in the country of establishment tax the equivalent transaction. If the transaction is not taxed in that state double-taxation is less likely to occur due to clashes between consumption tax systems. Those companies should, however, be aware of if changes in the criteria of fixed establishment within EU occur, since it may affect their organisation and possibly also their competitiveness.

View of the OECD Definition for Income Tax Persons

The OECD Model Tax Convention, provides a definition for income tax purposes of a permanent establishment, "...a *fixed place of business through which the business of an enterprise is wholly or partly carried on.*"(Art. 5) This definition is wider than the definition of fixed establishment by the ECJ but is not applicable for VAT purposes (above). Companies can thus have a permanent establishment within a state for income tax purposes, but not for VAT purposes. A good example of cases where this might occur is in e-commerce, where suppliers of digital services can, under certain conditions, have a permanent establishment where the server is located for income tax purposes but not for VAT purposes.

The commentary to the OECD MTC opens up for servers to constitute a permanent establishment for income tax purposes. Distinctions are made between servers and other computer equipment and data and software used by, or stored on the equipment. It is only the server and not a website that can constitute a permanent establishment. (See Commentary to art. 5, para. 42.2) A distinction is also made between carrying on business using an Internet Service Provider (ISP) and owning or leasing a server for the company's own disposal. It is only the later case that could constitute a permanent establishment. (See Commentary to art. 5, para. 42.3)

Personnel are not required at the location of the server, but the business needs to be wholly or partly carried on through the server. (See Commentary to art. 5, para. 42.6) If this is done should be evaluated on a case-by-case basis which also applies to which types of activities that are performed through the server. It should not be restricted to preparatory or auxiliary activities. (See Commentary to art. 5, paras. 42.5 and 42.7) Moving a server offshore to minimise taxes could be subject to rules related to hindering tax avoidance and harmful tax competition. The rules need to be examined on a case-by-case basis.

Several states, such as the United Kingdom and Italy, have opened up for the possibility of having differing views. (See e.g. Commentary to art. 5, paras. 45.5-45.10) One could also question the status of the commentaries to the OECD Model Tax Convention since its binding, or not binding effects are discussed frequently in literature. It may however be used as guiding for interpreting the articles in the Model Tax Convention (See e.g. para. 15 of the introduction to the OECD MTC)

The effects of using an Internet service provider for running an e-commerce business is thus less likely to establish both a fixed establishment for VAT purposes and a permanent establishment for direct tax purposes. Even running an e-commerce business with digital deliveries of services through a server owned by the company, may not constitute a fixed establishment for VAT purposes within EU, but the direct tax consequences are a bit more uncertain considering the OECD commentary. States have different opinions about whether a server may constitute a permanent establishment or not for direct tax purposes. (See e.g. Skaar 2000 and Villadsen 2001)

Thorough evaluation of both income tax and VAT consequences is recommended to be done before establishing new branches or change the structure of the organisation. Both positive and negative competitive effects could occur.

Effects for Established and Non-Established Companies Delivering Certain Digital Services

Companies established in an EU-state are subject to differing VAT rates between the different Member States. Even if the Regulation from 2005 gives guidance on what should and should not be treated as electronically

supplied services, uncertainty exists where services not brought up by the Regulation are classified by the national authorities. Since different rates may apply and this uncertainty exists, altering the applicable rate from a higher rate to a lower by changing the place of establishment or using a fixed establishment is one way for established companies to deal with tax consequences that may be seen as unfair from a competitive perspective. Altering the place of supply by creating a fixed establishment must, however, lead to a rational tax result and could be difficult.

Companies not established in an EU-state need to consider how having a fixed establishment within EU affects their competitiveness on the internal market. The companies need to evaluate the criteria for having a fixed establishment for VAT purposes and compare this to registering in one Member State as the state for identification in accordance with the special scheme provided for non-established companies providing electronically supplied services to EU-consumers. Both established and non-established companies need to be aware of the differences between fixed establishment for VAT purposes and permanent establishment for income tax purposes.

Altering the place of taxation by changing the place of the server or creating fixed establishments through other means could be regarded as steps to minimise taxation and possibly also tax evasion. It is clear in case law from the ECJ that *“...the question whether a given transaction is carried out for the sole purpose of obtaining a tax advantage is entirely irrelevant in determining whether it constitutes a supply of goods or services and an economic activity”*. (See case C-255/02, para. 59) The ECJ has, however also stated that the right to deduction of input VAT does not involve the right to deduct VAT where the transactions involves an abusive practice. In transactions between taxable persons where the competitiveness is partly dependent on the right to deduct input VAT, it is important to realise that the ECJ have opened up the possibility of making companies subject to repayment of VAT if proven that an abusive practice exists. In determining if an abusive practice exists *“...it is necessary, first, that the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and of national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage.”* (Case C-255/02, para. 89) It is too early to fully see the implications of the possibility of using this later case. It is however interesting and should not be ignored when evaluating possible VAT implications for established as well as non-established companies.

DECIDING THE PLACE OF SUPPLY

Supplies by Companies Established Outside EU

A company is regarded to be a non-established company when it does not have a fixed establishment for its business within EU or otherwise required to identify for VAT purposes. (Art. 358 (1) RVD) Such companies are subject to different rules depending on if they sell their services to consumers or taxable persons. In supplies to other taxable persons with an establishment in one of the EU-states, the supply is deemed to be made in the state where the purchaser is established. (Art. 56 (1) RVD) The EC VAT provides a reverse charge mechanism in these cases where the purchaser who is established in an EU-state is tax liable. (Art. 196 RVD) Since the purchaser is likely to have a right to deduct input VAT, the applicable VAT rate affects the supplying company's competitiveness to a lower extent than in supplies to consumers or non-taxable persons without a right to deduction. If the price for downloading a font is € 25 excluding VAT, and the applicable VAT rate is 25 per cent, the total price for a taxable person using the font in its economic activity equals the price excluding VAT, whereas a non-taxable person has to pay the price including VAT, € 31.25.

Supplies from non-established companies to consumers may fall under the special scheme introduced in May 2002 with rules that entered into force 1st July 2003 for a period of three years. (Dir. 2002/38/EC) The rules have in different steps been prolonged and are currently applicable until 31 December 2008 (Dir. 2006/138/EC) The background to the changes was that electronically supplied services from non-established companies within EU to consumers residing in EU where not subject to VAT, whereas supplies of the equivalent services from companies established within EU to non-EU customers where subject to VAT. This created a distortion in competition between established and non-established companies, not inline with the underlying principle of VAT neutrality. (See e.g. COM(2000) 349 final)

The special scheme for non-established companies covers the possibility for these companies to choose one Member State as the "Member State of identification", to which the company shall state when the taxable activity within the Community commences as well as details for the identification. (Arts. 360-361 RVD) The non-established company can then submit their VAT return electronically to the Member State of identification, showing for each Member State the supplies made to consumers in different Member States, the applicable VAT rates and the total VAT due. (Arts. 364-365 RVD) The applicable rate for the supplies is not dependent on the chosen Member State of identification, but dependent on where the consumers habitually resides.

Overall the principle of destination is guiding for deciding the place of supply. The reverse charge mechanism keeps the administrative burden for the supplying company at a lower level. In supplies to non-taxable persons the administration is more burdensome even if it is less

compared to if the non-established companies would have to register for VAT in each Member State and not register in one of them as the Member State of identification. Company A, from the example in the introduction, not established in an EU-state, thus needs to apply the VAT rate applicable in each of the Member States the supplies are destined to, which normally varies between 15 and 25 per cent if the standard rate is applied.

Supply by Companies Established within the EU

Current Rules Companies established in a Member State of EU, selling services to taxable persons established in other Member States, follow rules similar to those applicable for non-established companies. (Art. 56 (1) RVD) The principle of destination applies and a reverse charge mechanisms is used in these transactions as well, making the taxable purchaser liable for VAT in the Member State where it has its business or a fixed establishment. (Art. 196 RVD)

Supplies by established companies to non-taxable persons or consumers are treated differently compared to if the supplier is established outside EU. The supplies are deemed to be made in accordance with the origin principle, whereby the VAT rate in the country where the supplier has its business or a fixed establishment applies to the transaction. (Art. 43 RVD) The supplier is tax liable for the supplies. (Art. 193 RVD) Since the VAT rates in the EU-states differ, the country where the supplier has an establishment is a key issue for organising the business. Competitive advantages or disadvantages may follow the differentiation in the VAT rates since the price of the services is directly affected by the applicable rate and the consumer has no right to deduction.

There is a provision of use and enjoyment in the EC VAT to avoid cases of double taxation and non-taxation, shifting the place of supply from the origin principle to the destination principle. This provision does, however, not apply for supplies of electronically supplied services to consumers. (Art. 58 RVD) the new scheme of a mutual agreement procedure followed by an arbitration procedure might solve these issues. Further evaluation is, however, needed to fully see the implications for companies providing electronically supplied services. One might also ask if supplies of certain electronically supplied services should be taxed in accordance with the rates where the consumer normally resides or the place of consumption if this differs from where he or she normally resides. Could these rules be in conflict with the rules on free movement of services on the internal market?

Proposed Changes The proposal from 2003 addresses issues on strains on the VAT legislation due to reaching a functioning internal market, globalisation and technology changes. Overall the supplies of services have increased and take new forms, not least by an increase in cross-

border supplies. For trade between taxable persons, the use of a reverse charge mechanism which already exists is brought up as a good method for shifting the place of supply to where the customer is established. (COM (2003) 822 final, p. 3)

The first proposal addresses issues in transactions between taxable persons. The general rule would then be that the supply is deemed to be made where the customer is established and the reverse charge mechanism would make the purchasing taxable person tax liable. These rules exist already today for electronically supplied services, which means that the extension of the destination principle does not affect these supplies. One could, however, principally discuss if it is in the best interest of the common market to shift from an origin principle to a destination principle. This is an issue that could need further clarification in a long term perspective, not least setting it in relation to further harmonisation of e.g. rates.

The later amended proposal amends the already brought up proposal with services supplied to consumers or non-taxable persons. Several changes are suggested, not least related to the categorisation of different services and the introduction of a 'one-stop-shop mechanism' for services supplied to consumers on the internal market. The one-stop-shop mechanism is similar to the special scheme for non-established companies supplying electronically supplied services to consumers that are resident within EU.

The reason given by the Commission for altering the place of supply from an origin based principle to a destination based principle is to minimise the use of differentiating VAT rates between the Member States to gain competitive advantages. By shifting to a destination based rule for deciding the place of supply, the possibility of using the differences in VAT rates decrease. Since it is administrative burdensome for the supplying companies to use a destination based rule, a one-stop-shop mechanism is used to ease this burden.

Effects for Established and Non-Established Firms Companies not established in the EU today, selling electronically supplied services to non-taxable customers can choose between registering in an EU-state applying the special scheme for non-established companies and setting up a fixed establishment in an EU-state. Similarly companies already established in EU, change their place of establishment to gain competitive advantages. The proposed changes create equal treatment on the internal market of which rules that applies to the different supplies, since the principle of destination is used in both cases. It does not however ensure equal treatment on a national level in the Member States if supplies are classified differently. Cases of double taxation can still occur.

Companies established in an EU-state are likely to gain from the proposed changes, comparing their competitiveness with companies not established in an EU-state and thus creating a higher degree of

competition neutrality. The same questions raised for non-established companies can also be raised for established companies regarding the risks for differing interpretations and classifications of supplies and risks for double taxation.

Final Comments

There is uncertainty on the treatment of electronically supplied services within the VAT in EU today. Services involving little, or no, human intervention are likely to be classified as electronically supplied services. Evaluations of supplies should then be done on a case-by-case basis. There are risks of different treatments of exchangeable supplies on national level. Even if the Regulation from 2005 gives some guidance, the technological changes and the innovation of new types of services are ongoing, straining the interpretative measures given in the Regulation. The risks of different treatment on a national level is not only related to the classification of services, but also to considering companies as taxable persons or not and deeming if it has a fixed establishment or not in a Member State.

Altering the place of supply as in the proposed changes may solve some competitive issues between established and non-established companies, but the risks of differing treatment on national level is still apparent. In cases where double taxation might occur there is a possibility that a system of mutual agreements and an arbitration procedure will be enforced. This may solve certain individual cases, and is needed for companies where transactions are subject to double taxation. One question is however how these mutual agreements and arbitration procedures will enhance the possibilities to foresee tax consequences. It is the ECJ who has the final word of interpreting EC law today. How this is affected by a mutual agreement procedure and an arbitration procedure on a principal and a practical level need to be appraised.

As long as uncertainty exists related to the different issues brought up in this article, national authorities are likely to develop national guidelines. Guidelines should instead be continued to be developed on an EC level or even a more international level, as within the work in the OECD. The binding effects of guidelines from the OECD can be questioned and is discussed in literature, but within EC law clear obligations for the Member States exists. If a common ground cannot be reached other measures such as double tax agreements for consumption taxation might be suitable in the context of electronic commerce.

To keep prices low on downloaded material the applicable VAT rate is an important competitive factor. Organising the structure of the company to minimise the tax burden is accepted, but the development within EC VAT after the Halifax-case and a possible introduction of a

doctrine on abusive practice, need to be considered on a case-by-case basis.

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