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European Scrutiny Committee

Value Added Tax: EU proposals for reform and the implications of Brexit

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Numbering of documents

Three separate numbering systems are used in this Report for European Union documents:

Numbers in brackets are the Committee's own reference numbers.

Numbers in the form "5467/05" are Council of Ministers reference numbers. This system is also used by UK Government Departments, by the House of Commons Vote Office and for proceedings in the House.

Numbers preceded by the letters COM or SEC or JOIN are Commission reference numbers.

Where only a Committee number is given, this usually indicates that no official text is available and the Government has submitted an "unnumbered Explanatory Memorandum" discussing what is likely to be included in the document or covering an unofficial text.

Abbreviations used in the headnotes and footnotes

AFSJ	Area of Freedom Security and Justice
CFSP	Common Foreign and Security Policy
CSDP	Common Security and Defence Policy
ECA	European Court of Auditors
ECB	European Central Bank
EEAS	European External Action Service
EM	Explanatory Memorandum (submitted by the Government to the Committee)*
EP	European Parliament
EU	European Union
JHA	Justice and Home Affairs
OJ	Official Journal of the European Communities
QMV	Qualified majority voting
SEM	Supplementary Explanatory Memorandum
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union

Euros

Where figures in euros have been converted to pounds sterling, this is normally at the market rate for the last working day of the previous month.

Further information

Documents recommended by the Committee for debate, together with the times of forthcoming debates (where known), are listed in the European Union Documents list, which is published in the House of Commons Vote Bundle each Monday, and is also available on the parliamentary website. Documents awaiting consideration by the Committee are listed in "Remaining Business": www.parliament.uk/escom. The website also contains the Committee's Reports.

*Explanatory Memoranda (EMs) and letters issued by the Ministers can be downloaded from the Cabinet Office website: http://europeanmemoranda.cabinetoffice.gov.uk/.

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Introduction

The UK's system for value added tax (VAT) is based to a large extent on the EU's VAT Directive[1] and supplementary legislation. The purpose of the Directive is to facilitate the free movement of goods and services within the Single Market, notably by harmonising when and where the VAT liability arises (especially on cross-border sales); restricting which VAT rates national governments can apply to ensure a level playing field; and eliminating the need for controls on intra-EU trade of goods to ensure the correct amount of VAT is paid.

Since October 2017, the European Commission has tabled four separate proposals for a substantial overhaul of the way the EU's VAT system has operated, in one form or another, since 1992. In this Report, we discuss these four proposals in turn. They relate to the treatment of cross-border sales of goods; the flexibility of individual EU countries to vary their domestic VAT rates; special schemes for small businesses to ease the burden of collecting VAT; and cooperation between the Union's national tax authorities to combat fraud. We have also focused on the implications of Brexit for the UK's domestic VAT regime, and the consequences for UK-EU trade.

Until it ceases to be a Member State, the UK will have a veto over any new EU tax legislation.

Background

The system for cross-border VAT within the Community was created in 1967, and although modified throughout the 1970s and 1980s, the basic approach has remained effectively unchanged until the advent of the Single Market. VAT was paid in the Member State of consumption, and customs officers collected the tax on goods being moved between different countries within the Community at the border.

In 1985, to create a true Internal Market for goods, the European Commission proposed the full abolition of border controls on goods moving between Member States. This, it acknowledged, would be a substantial change in the way goods moving between different EU countries were assessed for VAT. A proposal was made to shift the VAT liability for cross-border transactions to the 'origin' principle, meaning it would be paid to, and at the rate of, the country of the supplier. This would most closely resemble the system for domestic sales, and thus create a 'true' internal market. It failed because Member States could not agree on the necessary harmonisation of VAT rates.[2]

Instead, the Member States pressed on with abolition of intra-EU customs controls from 1992 and created a "transitional" VAT system—still in effect as of 2018—based on the 'destination' principle. With the central role of the customs officers gone, the responsibility to account for VAT was put on the buyer in the destination country. In practice, this meant that a cross-border supply of goods was made at a zero-rate, after which the buyer would effectively charge themselves VAT and pass this to their national tax authority. The

1 Directive 2006/112/EC, as amended.

2 The 'origin principle' VAT proposals gave rise to significant political hurdles: the 'origin' principle requires harmonisation of VAT rates, because consumers and businesses would shift their purchases to the countries with the lowest rates lead to tax competition. Moreover, the introduction of the system itself would create a substantial revenue shift to Member States with large supply bases, reducing VAT revenue in other countries and therefore requiring some form centralised redistribution system between national governments

Member States also took a first step towards harmonisation of VAT rates, with a view to an eventual move towards the 'origin' principle, although they carved out country-specific exemptions for themselves (such as the UK's continued zero-rate for food and drink).

While this removed the need for border formalities, it also created enormous opportunities for fraud. Consequently, it also led to new administrative requirements for businesses, as well as intensified statutory cooperation between the EU's tax authorities, to monitor trade in goods and compliance with VAT law. A special "SME scheme" was created to exempt small businesses from charging VAT and provide them with other administrative simplifications.

The "definitive" VAT system

Between 1992 and 2010, the European Commission made several unsuccessful attempts to break the political deadlock on the introduction of the 'origin' principle for VAT on cross-border supplies within the EU.

As a consequence, it announced in 2011 that it would prepare legislation to replace the 'transitional' 1992 regime with a "definitive" VAT system, still based on the 'destination' principle, but one where the supplier in a cross-border transaction within the EU would become responsible for accounting for VAT as if it were a domestic sale. This would also allow more flexibility to be given to individual Member States to vary their VAT rates, as harmonisation of rates had been pursued primarily to lay the ground for the—now-abandoned—'origin' system.

Concrete legislative proposals to give effect to this new approach were introduced by the Commission between December 2016 and January 2018 (with technical proposals to follow later this year), including:[3]

- a single VAT area with a **'definitive' system for value added tax**, which would establish where the taxable event occurs and who is responsible for paying it to the relevant tax authority;
- a proposal on **VAT rates**, granting individual Member States more flexibility in setting domestic rates given that the 'origin' principle has been abandoned;
- a proposal on the **VAT obligations of smaller businesses**, to improve the scheme which exempts them from the need to charge VAT and certain other administrative requirements; and
- a proposal to strengthen **statutory cooperation between the EU's national tax authorities** to combat VAT fraud.

We have set out the substance and implications of each of these proposals in more detail in the chapters of this Report. While the content of the Commission proposals is undoubtedly important, it has been extremely difficult to effectively scrutinise the documents with respect to their potential impact in the UK. In the immediate period after Brexit, the Government's "implementation period", the UK would stay bound by EU VAT law and therefore part of the Single EU VAT Area.

3 A complete overview of recent EU proposals on value added tax considered by the European Scrutiny Committee is shown in the annex below.

However, the Treasury has been unable to provide any detail about its desired VAT arrangements for cross-border trade between the UK and the EU after that. The European Commission recently summarised the implications of an exit from the Single EU VAT area for UK businesses, absent a new legal agreement to the contrary, as follows:[4]

- any goods they export to the European Union will be treated as imports by EU customs authorities, with VAT liability to be assessed by customs officials at the border. Likewise, any goods imported from the EU will attract a VAT liability as soon as they enter the UK (as these transactions would no longer be zero-rated), creating cash flow issues for smaller businesses in particular;

- businesses which sell goods to other EU countries will no longer benefit from the distance selling threshold allowing them to account for VAT in the UK on such transactions up to a certain value of annual exports;[5]

- UK businesses exporting low-value consumer items to the EU will temporarily benefit from the Low Value Consignment Relief, meaning sales under €22 (£19)[6] will not attract VAT, until this relief is abolished in 2021;

- if a UK company incurs a business expense in the EU for which they want to claim a VAT refund, they will have to file a paper-based application as the current electronic system is only available for EU businesses. In addition, individual EU countries can make the granting of such refunds subject to reciprocity, requiring an arrangement with HM Revenue and Customs;

- before a UK business can make a taxable sale in 19 out of 27 EU Member States, they would have to be required to designate a tax representative as the person liable for payment of the VAT;[7] and

- UK-based businesses who supply telecommunications services, broadcasting services or electronic services to consumers in the EU will need to register for VAT in an EU Member State to make use of the Mini One Stop Shop VAT accounting mechanism.[8]

However, as we explain in the different chapters of this Report, the Treasury appears to assume it could still be bound, or constrained, by EU law when setting the UK's domestic VAT system in 2022 and beyond. Whether that is because of the length of the post-Brexit transitional period (during which EU law will continue to apply), or because the Government is minded to pursue continued 'alignment' with the UK on matters of vale added tax in the long-term, effectively staying in the single EU VAT area, is unclear.

Brexit, effectively, presents a trade-off:

- If the UK comes to an agreement with the EU on continued adherence to the VAT Directive and its supplementary legislation, it may be able to avoid the barriers to trade described above, including the need for VAT-related border

4 Notice to Stakeholders on Brexit and customs & indirect taxes (30 January 2018).
5 See our Reports of 22 November 2017 and 24 January 2018 on VAT on e-commerce within the EU.
6 €1 = £0.88415 or £1 = €1.13103 as at 28 February.
7 See https://www.vatlive.com/vat-news/uk-to-leave-eu-vat-regime-31-December-2020/.
8 The Mini One Stop Shop allows suppliers of certain electronic services to consumers in another EU country to pay the VAT to their national tax authority, which then remits it to their counterpart in the Member State of the consumer. See for more information our Report of 22 November 2017 on VAT and e-commerce.

controls on goods exported to an EU country after Brexit. However, this would come at the cost of having to follow legislation over which the Government will have substantially less influence than it does now (considering that, under the Treaties, Member States can veto EU tax legislation).

- If the Government does not want an arrangement with the EU to remove VAT-related obstacles that entails continued adherence to EU VAT law, there are likely to be new—and substantial—barriers to trade with the EU. This would pose a particular problem for the Irish border: without either UK participation in the EU system used to track movement of goods[9] *or* physical border controls, products could pour into the UK (and the EU) without VAT being paid.[10]

In this Report, we have again urged the Government to set out how it intends to balance these competing pressures, and how collection of VAT on imports can be guaranteed on goods entering the UK via Ireland in the absence of any physical infrastructure on the border.

9 The VAT Information Exchange System (VIES), which is only available to EU Member States applying EU VAT law.

10 The European Commission, in the draft Withdrawal Agreement, proposed as a fall-back option that Northern Ireland could remain part of the Single EU VAT Area and continue applying EU VAT law indefinitely to circumvent this problem. However, this would effectively shift the customs border to the Irish Sea, in between Northern Ireland and Great Britain.

Annex: Recent EU VAT proposals

Proposal	Proposed	Document reference	Scrutiny status
VAT: services and distance sales of consumer goods	December 2016	38341	Cleared on 24 January 2018
VAT: location of customers	December 2016	38342	Cleared on 24 January 2018
VAT: administrative cooperation on consumer goods	December 2016	38343	Cleared on 24 January 2018
VAT on books and newspapers	December 2016	38344	Cleared on 25 January 2017
Reverse charge mechanism for domestic B2B transactions	December 2016	38432	Cleared on 25 April 2017
Definitive VAT system	**October 2017**	**39085**	**Remains under scrutiny. Last considered on 28 March 2018.**
Proof of intra-Community supply	October 2017	39084	Cleared on 6 December 2017
VAT: Certified Taxable Persons	**October 2017**	**39083**	**Remains under scrutiny. Last considered on 28 March 2018.**
EU-Norway VAT Cooperation Agreement	October 2017	39174; 39175	Cleared on 6 December 2017
VAT: administrative cooperation to tackle fraud	**December 2017**	**39299**	**Remains under scrutiny. Last considered on 28 March 2018.**

Proposal	Proposed	Document reference	Scrutiny status
Minimum standard rate of VAT	December 2017	39391	Cleared on 28 March 2018.
VAT: flexibility to set reduced rates	**January 2018**	**39448**	**Remains under scrutiny. Last considered on 28 March 2018.**
SME exemptions from VAT	**January 2018**	**39449**	**Remains under scrutiny. Last considered on 28 March 2018.**

1 Single EU VAT Area

Committee's assessment	Politically important
Committee's decision	Not cleared from scrutiny; further information requested; drawn to the attention of the Business, Energy & Industrial Strategy, the Northern Ireland Affairs and Treasury Committees
Document details	(a) Proposal for a Council Directive harmonising and simplifying certain rules in the value added tax system and introducing the definitive system for the taxation of trade between Member States; (b) Proposal for a Council Regulation as regards the certified taxable person
Legal base	Article 113 TFEU; special legislative procedure; unanimity
Department	Treasury
Document Numbers	(a) (39085), 12882/17 + ADDs 1–2, COM(17) 569; (b) (39083), 12880/17, COM(17) 567

Summary and Committee's conclusions

1.1 Since October 2017 the European Commission has tabled four legislative proposals—six years in the making[11]—to begin a substantial reform of the EU's value added tax (VAT) system and create a 'true' single EU VAT area.

1.2 The proposal we discuss in this chapter is focussed on the VAT treatment of cross-border business-to-business[12] sales of goods and services within the EU, with the aim of introducing the "definitive" system of value added tax for such transactions. The other three elements of the VAT reform package relate to VAT rates, exemptions for small businesses, and administrative cooperation between national tax authorities in the EU. We have discussed these in the other three chapters of this Report.

1.3 The Commission proposal for the "definitive" VAT system on cross-border sales builds on a system—first introduced on a 'transitional' basis in 1992—which allowed for the complete abolition of customs and tax controls on goods moving between EU countries. Under the new legal framework drafted by the Commission, VAT on intra-EU business-to-business (B2B) sales would continue to be paid to the Member State of the company making the purchase (the so-called 'destination' principle).

1.4 However, the proposed legislation would end the current practice of making the purchaser account for the VAT (the so-called "reverse charge mechanism"), a key feature of the transitional system. Instead, the supplier would have to account for the VAT, as is the case for purely domestic transactions. While increasing the burden on businesses

11 The outline of the proposal was first announced in the Commission's 2011 Communication on the Future of VAT.

12 Different EU rules apply to cross-border business-to-consumer sales. See our Report of 24 January 2018 on VAT and cross-border e-commerce for more information.

wishing to sell goods or services to another EU country, it would end a current loophole that incentivises so-called widespread "missing trader" fraud (estimated to cost EU governments £44 billion annually).[13]

1.5 To mitigate the impact of this change on suppliers, the Commission has simultaneously proposed to expand the use of an EU-wide mechanism that allows suppliers to pay VAT on sales to any Member State in their own country (the so-called "One Stop Shop" or OSS), and enabling businesses to deduct input VAT via this system.[14] Moreover, the current reverse charge mechanism would be maintained for transactions where the buying business had "Certified Taxable Person" (CTP) status, meaning they were officially considered a reliable taxpayer, unlikely to engage in VAT fraud. In parallel, the Commission wants to introduce a number of 'Quick Fixes' to reduce VAT-related burdens on businesses and remove opportunities for fraud while the broader reforms are under consideration.

1.6 The Government cautiously welcomed the proposals, but told us in October that further detailed consideration would be necessary. In particular, the Financial Secretary to the Treasury (Mel Stride) highlighted the problems that could arise from two parallel systems of accounting for VAT depending on whether the buyer is a "reliable taxpayer" or not; the potential impact of changes to cash flow that both tax authorities and businesses may experience as a result of the proposed changes; and the need for further scrutiny to ascertain what new opportunities for VAT fraud the proposals might create. The Minister did not assess the implications for UK businesses, both buyers and suppliers, of leaving the EU's common system of VAT.

1.7 The Committee considered the proposal in December 2017, and retained it under scrutiny. We expressed concern about the lack of clarity from the Government about its plans to mitigate the VAT-related barriers that Brexit would, by default, impose on UK-EU trade flows unless a new agreement is in place by the time the UK is due to leave the single EU VAT area (at the end of the post-Brexit transitional arrangement, the end date of which is not yet known).

1.8 When the UK ceases to be bound by EU VAT law, VAT will become an import tax on goods going in either direction, including customs controls which are currently absent due to the UK's membership of the Single Market. UK businesses would cease to benefit from the systems and mechanisms in place to minimise VAT-related barriers to trade within the EU, such as the One Stop Shop. Conversely, the Government would no longer be restricted by EU law when setting VAT rates and administrative requirements for businesses.[15] It appears the Government is seeking to remain aligned with EU VAT law to minimise new barriers to trade, as it has not told the Committee with respect to any of the VAT reform proposals that it categorically will not apply to the UK (despite the fact they are unlikely to take effect until 2022 at the earliest).

1.9 With respect to the substance of the Commission proposal for the "definitive" system, the Financial Secretary to the Treasury (Mel Stride) was cautiously optimistic about the thrust of the reforms. However, he highlighted concerns about the creation of two parallel systems for VAT on identical cross-border transactions (with responsibility lying with

13 See "Background" below for more information on missing trader fraud under the current system.

14 At present, an embryonic version of the One Stop Shop is available only to businesses who sell electronic and broadcasting services to consumers based in another EU country.

15 See for more information on EU rules on VAT rates the separate chapter in this Report.

the buyer if they had CTP status, and with the vendor if they did not). Moreover, the European Commission will only set out its proposals for the technical detail that would underpin the new system in the form of an Implementing Regulation later this year.

1.10 The Minister wrote to the Committee in February 2018 with more information on the discussions on the proposal within the Council so far.[16] He noted there was particular opposition to the expansion of the One Stop Shop and its potential use to deduct input VAT and the added value of the "Certified Taxable Person" status, the core elements of the Commission proposal to end the use of the reverse charge mechanism for cross-border B2B sales within the EU. With respect to the VAT-related trade barriers that Brexit would impose in the absence of a new agreement with the EU, he said only that "arrangements" would "depend on" the upcoming trade negotiations.

1.11 **As we have noted before, the European Commission's VAT reform proposal for cross-border supplies is substantive and far-reaching. If implemented in the UK, it will affect businesses, consumers and the Exchequer alike. We note that there is substantial national opposition to key parts of the proposal, with both the expansion of the One Stop Shop and the introduction of the "Certified Taxable Person" status attracting criticism within the Council. This means the timetable for adoption of the new legislation, and consequently its entry into force, remains highly uncertain.**

1.12 **In any event, we cannot properly scrutinise the proposals without taking into account Brexit. The UK's exit from the EU has significant consequences for the VAT treatment of UK goods and services exported to the European Union. Absent an unprecedented agreement to the contrary, UK goods sent to the EU will face VAT controls at the border for the first time since 1992, posing particular problems at the border on the island of Ireland.[17] British businesses would also no longer be able to make use of the Mini One Stop Shop simplified accounting mechanism for sales to EU-based consumers without registering for VAT in another EU country, and have to revert to paper-based applications for VAT refunds on business expenses incurred in the EU.**

1.13 **The Committee remains seriously concerned about the inability, or unwillingness, of the Government to share a detailed proposition for the mitigation of VAT-related barriers to trade flows between the UK and the EU as and when the UK leaves the single EU VAT area (either in March next year or at the end of any subsequent transitional period). In his latest letter, the Financial Secretary is able to offer us only the obvious insight that "arrangements in this regard will depend on the conclusion of the negotiations".**

1.14 **Plainly, that does not tell us what the Government hopes those arrangements would, ideally, be. As we have noted in the other chapters of this Report, the Minister's Explanatory Memoranda on the various elements of the VAT reform package strongly suggest the Government is considering remaining closely aligned with, if not directly bound by, EU VAT law to minimise barriers to trade with the EU after Brexit.**

16 Letter from Mel Stride to Sir William Cash (19 February 2018).

17 In the draft Protocol on Ireland annexed to the Withdrawal Agreement, the EU has proposed that Northern Ireland should stay in the EU's VAT and excise area to avoid the need for border controls on the island of Ireland itself.

1.15 **In any event, the UK will be under an obligation to continue applying EU VAT law for the duration of any transitional period from March 2019 onwards. It cannot yet be ruled out that the VAT reform package—including the proposal on the "definitive" system for cross-border supplies—will have to be implemented in the UK. As we have stated previously, this raises a potentially serious problem: when the UK ceases to be a Member State, it will lose its Treaty-based veto over new EU tax legislation. The Government could then find itself in the position of having to implement VAT legislation which it would have blocked had it still been a member of the Council.**

1.16 **It does not appear that the safeguarding mechanism the Government is seeking would allow the UK to unilaterally reject new EU VAT legislation that takes effect during the transition without potentially triggering the re-imposition of customs controls on UK goods entering the EU.**[18]

1.17 **Moreover, in the area of VAT, EU law creates a symmetrical and reciprocal system to ensure proper taxation of cross-border supplies; a refusal by the UK during the transition to implement changes adopted by the remaining Member States could undermine the feasibility of the UK's continued participation in the system altogether. To take the "definitive VAT" proposal, it is not clear how the UK could—by way of example—unilaterally reject the eventual abolition of the reverse charge mechanism and use of the One Stop Shop for cross-border sales while it remains part of the single EU VAT area if it *was* abolished by the EU-27. That would render it unclear who was accountable for VAT on sales of goods from the EU to the UK: HM Revenue & Customs would require the vendor to account for the tax, while the EU-based supplier would simultaneously expect to have to account for the VAT through the One Stop Shop.**

1.18 **While this is an extreme example, any decision by the UK to diverge from the harmonised standards that underpin the common VAT system could have unforeseen consequences, potentially rendering the whole cross-border system that allows for border controls to be waived technically unworkable.**

1.19 **As such, it could be that the Government's long-term objective is continued alignment with EU VAT legislation beyond the transition, to maintain the "freest and most frictionless trade possible". This is our interpretation of the various Explanatory Memoranda we have received from the Treasury, which appear to assume the VAT Directive could still restrain the Government's domestic room for manoeuvre in 2022 and beyond. However, any arrangement that sees the UK having to keep in lock-step with EU VAT law indefinitely raises serious issues about the extent to which the UK would have freedom post-Brexit to modify the fundamentals of a major part of its tax system. Therefore, the Committee will continue to monitor negotiations on the proposal as its substance develops within the Council.**

1.20 **The Committee looks forward to receiving further information from the Minister about the Government's proposals for a new UK-EU arrangement on VAT, and in particular how a trade agreement with the EU could ensure value added tax is collected on goods imported into the UK via the border with Ireland (given the**

18 The draft Withdrawal Agreement allows the EU to unilaterally suspend parts of the Agreement or any other Agreement with the UK if it considers that the UK has failed to interpret or apply the Agreement correctly.

Government's objective of avoiding any physical infrastructure there). We also ask to be kept informed of progress in the negotiations on the "definitive" VAT proposal, in particular as regards the Member States' alternative proposals to end the use of the reverse charge mechanism for business-to-business supplies while still closing the current loophole allowing for rampant missing trader fraud on cross-border sales. In the meantime, we retain the proposal under scrutiny.

Full details of the documents

(a) Proposal for a Council Directive harmonising and simplifying certain rules in the value added tax system and introducing the definitive system for the taxation of trade between Member States: (39085), 12882/17 + ADDs 1–2, COM(17) 569; (b) Proposal for a Council Regulation as regards the certified taxable person: (39083), 12880/17, COM(17) 567.

Background

1.21 Since 1993, with the complete abolition of intra-EU customs controls as part of the Single Market, the EU has operated a curious system of Value Added Tax (VAT) on cross-border business-to-business (B2B) sales within the EU. Under this system, a supplier can make a sale of goods or services to a customer in another EU country at a zero-rate of VAT, after which the customer effectively must charge VAT to himself and pay it to their national tax authority.[19]

1.22 This system was meant to operate only on a transitional basis, as it allows for substantial amounts of VAT to be fraudulently evaded on goods through missing trader fraud (estimated to cost EU Governments up to €53 billion (£47 billion)[20] each year).[21] After repeated efforts to end the 'transitional' phase by shifting the responsibility of accounting for VAT to the supplier at their domestic rate (the so-called 'origin' principle)—which would most closely reflect a 'true' internal market by eliminating differences in VAT treatment faced by suppliers for domestic and intra-EU sales—the European Commission and Member States in 2011 decided to fully implement the transitional 'destination' based system instead, where the VAT must be accounted for in the country of consumption.

1.23 In October 2017 the European Commission tabled a legislative proposal to this effect. The main elements of the proposal are:

- to end the reverse charge mechanism, meaning that suppliers, and not buyers, would become responsible for accounting for VAT on cross-border business-to-business sales, at first for goods only and for cross-border supplies of services at

19 In 2013, the European Commission estimated that VAT on cross border B2B supplies within the EU amounted to around €600 billion (£510 billion) each year and involved between 3.2 and 3.7 million firms. For imports into the EU from non-EU countries (including from the UK when it leaves the EU after Brexit), VAT must still be paid at the border before it can enter the EU's territory.

20 €1 = £0.88415 or £1 = €1.13103 as at 28 February.

21 Intra-EU missing trader VAT fraud takes place when the company buys goods from another Member State, because purchasing the goods is VAT-free. When selling the goods on domestically, the company receives the entire amount of VAT, which it pockets rather than transferring it to the Treasury. Because the company disappears, this type of fraud is called missing trader fraud. Carousel fraud takes this a step further: the same goods are bought and resold by the fraudster several times via middlemen, and each time the amount of collected VAT increases and the company either disappears or becomes insolvent before the tax authority can collect the accumulated VAT.

a later stage. This would end the use of zero-rating of cross-border supplies that provides opportunities for missing trader fraud, as the supplier would have to charge VAT when selling to a business based elsewhere in the EU;[22]

- to mitigate the impact of this change on suppliers by expanding the use of an EU-wide mechanism that allows suppliers to pay VAT on sales to any Member State in their own country (the so-called "One Stop Shop" or OSS),[23] and by retaining the reverse charge mechanism where the buying business had "Certified Taxable Person" (CTP) status (i.e. they are a reliable taxpayer); and

- lastly, in recognition of the likely lead-in time for these reforms to take effect, to introduce a number of so-called 'Quick Fixes' to mitigate VAT fraud and reduce burdens on businesses in the interim, including increased use of the VAT identification number; new evidentiary standards for proof of intra-EU supplies to reduce cross-border VAT evasion; and new VAT treatment of call-off stock and chain transactions of goods.[24] The Commission has proposed that most of the improvements offered by its "Quick Fixes" would only be available where the supplier has the new "Certified Taxable Person" status, to incentivise take-up of the CTP scheme.

1.24 the Government cautiously welcomed the proposals, but told us in October 2017 that further detailed consideration would be necessary. In particular, the Financial Secretary to the Treasury (Mel Stride) highlighted the problems that could arise from two parallel systems of accounting for VAT depending on whether the buyer is a "reliable taxpayer" or not; the potential impact of changes to cash flow that both tax authorities and businesses may experience as a result of the proposed changes; and the need for further scrutiny to ascertain what new opportunities for VAT fraud the proposals might create. The Minister did not assess the implications for UK businesses, both buyers and suppliers, of leaving the EU's common system of VAT.

1.25 The Committee considered the proposal in December 2017, and retained it under scrutiny because:

- the Commission proposals are a major development in the EU's common system of value added tax, as they are the first significant step in ending a system for cross-border VAT within the EU that was introduced nearly twenty-five years ago as a temporary measure;

- our ability to effectively scrutinise the Commission's proposed Directive is hampered by the fact that its proposal for the detailed, technical implementation of the "definitive VAT system" will not follow until later this year;

22 The Commission's 2017 proposal would only legislate for the principle of moving to a new system of cross-border VAT for B2B sales, with further detailed draft legislation to follow later in 2018. The Commission estimates that its plans, if adopted by the Member States, would result in a reduction in VAT fraud of €41 billion (£37 billion) and compliance costs for businesses by €1 billion (£890 million) annually.

23 At present, an embryonic version of the One Stop Shop is available only to businesses who sell electronic and broadcasting services to consumers based in another EU country.

24 The Committee set out the substance of the "Quick Fix" proposals in some detail in its Report of 6 December 2017.

- during the post-Brexit transition period, any changes to VAT law—including potentially this proposal—would apply to the UK if they take effect during that period; and
- there remains considerable uncertainty surrounding the long-term implications of Brexit for the UK's VAT system, and the extent to which the Government may wish to stay aligned with EU VAT law to minimise VAT-related barriers to trade between the UK and the EU that are currently absent. In particular, such alignment would be necessary to avoid the need for VAT controls at the border on flows of goods between the UK and the EU, and to allow UK-based businesses to make full use of the various mechanisms EU law has created to remove or mitigate the VAT-related obstacles to intra-EU cross-border trade.[25]

1.26 We therefore asked the Minister for further information on the Brexit implications for the UK's VAT regime; the Government's position with respect to the "definitive" VAT system proposal; the accuracy of the Commission's impact assessment, in particular the envisaged €41 billion reduction in VAT fraud; the value of the new "Certified Taxable Person" status; and whether the 'Quick Fixes' might be dealt with separately to expedite their entry into force.

The Minister's letter of 19 February 2018

1.27 The Financial Secretary to the Treasury (Mel Stride) replied to the questions raised by the Committee in our Report of 6 December 2017 by letter of 19 February.[26]

1.28 With respect to the VAT-related trade barriers that will impede UK-EU flows of goods and services as and when the UK leaves the single EU VAT area (and with it the system that enables goods to be moved between EU countries without customs controls), the Minister says only:

> "The UK's arrangements in this regard will depend on the conclusion of the negotiations. However, as the Government has made clear, the UK will seek a deep and special partnership with the EU, one which is based on strong and mutual respect and friendship and one which is based on as free and frictionless trade in goods and services as possible."

1.29 As such, it is still not possible for the Committee to categorically rule out that the new VAT system on cross-border supplies—or the supplementary proposals on VAT rates, exemptions for small businesses, and administrative cooperation between tax authorities—will not apply in the UK. Indeed, the Government's Explanatory Memoranda on the various elements of the VAT reform package, which we discuss elsewhere in this Report, implicitly assume they may apply in the UK, even though they are not due to take effect until 2022 at the earliest.

1.30 As such, the remainder of the Minister's letter (on the substance of the Commission proposal) remains relevant. We have summarised it below.

25 See the introduction to this Report for more information on the possible implications for UK businesses of leaving the Single EU VAT area. The Committee also discussed these in more detail in its Reports of 6 December 2017 and 24 January 2018.

26 Letter from Mel Stride to Sir William Cash (19 February 2018).

The "definitive" VAT system

1.31 The Committee had asked the Minister about the merits of agreeing the principles of the proposed changes, while leaving the detailed implementation to a later stage. He now writes that the Government "would prefer to see greater detail from the outset regardless of the opportunity for input during discussion on the implementing regulation".

1.32 As regards the accuracy of the Commission's impact assessment—namely that the proposals would reduce VAT fraud in the EU by over €40 billion annually—the Government is agreement that the taxation of cross-border B2B supplies as proposed "is likely to eliminate Missing Trader Intra-Community (MTIC) fraud in its current form", but could "provide new opportunities for variants of missing trader or other forms of fraud". The precise impact of the proposal on business costs (which the Commission said would be reduced by nearly €1 billion per year) is "difficult to establish" precisely, according to the Minister, although he notes the assessment was driven by three assumptions:

- non-established suppliers may no longer need to register for VAT in other Member States (or submit local VAT returns and an intra-EU sales list) by using the One Stop Shop;
- Similarly, the requirement to submit an intra-EU sales list to account for cross-border supplies to businesses would be removed when there is no zero-rated intra-EU acquisition; and
- Businesses generally would benefit from the standardisation of reduced VAT rates for goods and the provision of information on applicable VAT rates online (as proposed in a separate Directive).

1.33 These elements remain under discussion, and the One Stop Shop proposal in particular is likely to face significant opposition within the Council (see below).

The extension of the One Stop Shop for cross-border supplies

1.34 With respected to the proposed extension of the One-Stop-Shop (OSS), which would allow a supplier to account for VAT on a cross-border sale to their national tax authority at the rate of the Member State of consumption, the Minister tells us that "discussions […] have been limited", although there is a "willingness to explore the issue further". However, some Member States "continue to have fundamental problems with the OSS system" which they are likely to raise again in the discussions on this proposal.

1.35 In any event, even most of the Member States open to further discussion of the extension of the OSS has "expressed misgivings over the proposed changes to allow deductibility of input VAT through the OSS", as this notion was already rejected in previous discussions on the Mini One Stop Shop for suppliers of electronic services "over fraud concerns".

The "Certified Taxable Person"

1.36 As regards the introduction of the "Certified Taxable Person" status for reliable taxpayers with lower risk of perpetrating VAT fraud (and therefore able to benefit from the 'Quick Fixes' that would reduce administrative burdens), the Minister explains:

> "Most Member States have questioned how consistency of approach and application could be achieved and how the proposed changes would work in practice, including over the resources required to grant and effectively monitor continued compliance with CTP criteria; whether the proposed criteria were the most suitable; the difficulties that new businesses may face in proving financial credibility; and how such criteria would be applied consistently across all Member States."

1.37 In terms of the assessment of applications and impacts on tax administrations of having to enforce the CTP concept, the Minister adds that "the proposals do not address the technical detail of how the changes would work in practice", including for example in relation to the Commission's proposed requirement that a criminal history check would have to be made before CTP status could be granted.

The "Quick Fixes"

1.38 The European Commission had proposed to link the "Quick Fixes"—which aim to reduce administrative burdens and close some known loopholes for VAT fraud as an interim measure—to the "Certified Taxable Person" status, meaning that their use would be mostly restricted to businesses which have obtained such status.

1.39 The Minister notes that this link "appears unpopular among Member States, the majority of whom favour swift agreement on the 'quick fix' changes as they recognise progress on the concept of CTP is likely to be difficult". However, at this stage it is not yet known if the "Quick Fix" elements could be split off from the main proposal to expedite their adoption and entry into force.

Previous Committee Reports

Fourth Report HC 301–iv (2017–19), chapter 9 (6 December 2017).

2 VAT: flexibility to reduce rates

Committee's assessment	Politically important
Committee's decision	(a) Not cleared from scrutiny; further information requested; drawn to the attention of the Business, Energy & Industrial Strategy and Treasury Committees; (b) Cleared from scrutiny
Document details	(a) Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax; (b) Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax, with regard to the obligation to respect a minimum standard rate
Legal base	Article 113 TFEU; special legislative procedure; unanimity
Department	Treasury
Document Numbers	(a) (39448), 5335/18 + ADDs 1–3, COM(18) 20; (b) (39391), 15904/17, COM(17) 783

Summary and Committee's conclusions

2.1 All EU Member States have to impose Value Added Tax as a condition of their Union membership. The EU's current VAT system, which in essence dates back to the advent of the Single Market in 1992, is built around a "transitional" system for cross-border VAT—still in effect a quarter of a century later—based on the 'destination' principle, where VAT on cross-border sales of goods and services is paid in the Member States of consumption. However, until 2011, the formal objective was to change this to a system based on the 'origin' principle—under which VAT is paid in the Member State of the supplier.

2.2 While the 'origin' principle would allow the EU as a whole to more closely resemble a true single market (because VAT would be paid by, and refunded to, suppliers in the same way for both intra-EU and domestic transactions), it raised intractable political problems. In particular, it would incentivise individual countries to lower their VAT rates to attract additional custom for their businesses—risking distortion of competition—and shift tax revenue to those Member States where suppliers are based (see paragraphs 2.25 to 2.27 in "Background" below).

2.3 One of the proposed solutions to this was a gradual harmonisation of VAT rates.[27] The 1992 VAT Directive therefore required all EU countries to apply a standard rate of 15 per cent to all goods and services, but with two categories of derogations: a 'positive list' of goods and services (in Annex III to the Directive) to which any Member State could apply a reduced rate higher than 5 per cent, and a series of country-specific derogations that reflected the level of VAT charged in those Member States in January 1991.[28] This is why

27 The 'origin' principle also required a centralised redistribution mechanism to ensure flows of VAT revenue from Member States of production to Member States of consumption. EU countries could not agree on the workings on such a mechanism either.

28 There are also a number of services which are mandatorily exempt from VAT, but without the right to deduct input VAT, such as financial and insurance services..

the VAT Directive allows the UK, for example, to continue applying zero-rates to food and drink, even though other Member States have to apply at least the reduced rate to those categories under the same legislation.

2.4 In 2011, after nearly twenty years of failed efforts to further harmonise VAT rates and abolish these country-specific exemptions, the European Commission and the Member States concluded that the objective of an 'origin' principle-based VAT system should be abandoned, and the transitional 'destination'-based approach instead become the "definitive" system.[29] Among other things, this removed the need for the current restrictions on—and any further harmonisation of—Member States' domestic VAT rates, as a system under the 'destination' principle does not carry the same risk of competitive lowering of rates (see paragraph 2.25).

2.5 In January 2018, as part of a wider package of reforms to make the 'destination'-based system permanent, the European Commission tabled a proposal to overhaul the restrictions EU law places on VAT rates. In particular, it would effectively reverse the current approach (where the standard rate must be applied unless a derogation, general or country-specific, is permitted): under the Commission proposal, Member States would be free to apply reduced or even zero-rates of VAT to any good or service, except for those specifically listed (to which the standard rate would have to be applied).[30]

2.6 The Commission has also tabled a proposal to maintain the statutory minimum of 15 per cent for the standard rate of VAT, which technically expired at the end of 2017. This proposal is uncontroversial as no Member State has expressed an interest in lowering its standard rate below that threshold.

2.7 The Financial Secretary to the Treasury (Mel Stride) submitted an Explanatory Memorandum on the VAT rates proposal on 8 February 2018.[31] The Government supports the Commission's intention to substantially increase the flexibility for Member States to reduce VAT rates for more categories of goods and services. The Minister notes in particular that the proposed changes would mean Member States would have the ability to apply a zero-rate of VAT to women's sanitary products, a flexibility which has long been sought by the UK Government.[32]

2.8 However, given that the Commission proposal explicitly notes that the new VAT rates system would not take effect until 2022 at the earliest, it is striking that the Minister does not indicate the proposal would not have a direct impact on the UK. Indeed, the Explanatory Memorandum indicates the Government has begun a 'mapping exercise' to identify how the proposal could impact on the UK's current reduced and zero-rate exemptions.[33] That indicates that either the Government believes the post-Brexit transitional arrangement

29 See Commission document COM(2011) 851.

30 According to the Commission, this approach—and its draft for the 'negative list'—would allow all Member States to maintain their current reduced or zero-rates, except for three Member States having to "abolish a reduced rate for wine" and for one further country which would have to abolish "a reduced rate for short-term hire of means of transport". The Commission also considered a second option, which would maintain the 'positive list' (i.e. goods and services to which a reduced rate could be applied), while also incorporating all the country-specific exemptions as general derogations into the VAT Directive, available for any Member State to use.

31 Explanatory Memorandum submitted by HM Treasury (8 February 2018).

32 At present, only Ireland can zero-rate women's sanitary products, as it already applied this rate on 1 January 1991 and this was consequently 'grandfathered' into the post-1992 VAT Directive.

33 For example, if one of the UK's current derogations was—inadvertently—caught by the new 'negative list' where the standard rate must apply.

(during which the UK will have to continue applying VAT law) may last well into 2022, or that it is considering seeking continued participation in the EU's common VAT area afterwards to minimise new trade friction arising from VAT being charged as an import tax on goods flowing between the UK and the EU after Brexit (or, potentially, both).[34]

2.9 **We note the proposed amendments to the VAT Directive would provide the UK with the flexibility the Government has sought to vary rates for specific goods and services, such as women's sanitary products. However, it is unclear whether the Government would have preferred the alternative considered by the Commission (namely, to maintain a 'negative list' of specific goods and services to which reduced rates of VAT can be applied, but to add all the country-specific derogations that currently exist—such as the UK's zero-rates on food—for all Member States to use).**

2.10 **The negotiations on this VAT rates proposal will take place in parallel to the other changes proposed by the Commission to the VAT Directive and its supplementary legislation, including on the taxation of cross-border transactions, a special scheme for small businesses, and administrative cooperation between the EU's tax authorities. As these all need to be agreed before the new system can take effect, and tax matters are subject to the veto of any EU country, the negotiations are likely to be protracted.**

2.11 **For the UK, the implications of the proposal are inextricably linked to its post-Brexit relationship with the EU's common VAT area after Brexit. If the UK, as a 'third country' like Norway, is completely outside of that area when the 'definitive' VAT system takes effect, the Government would in any event have full flexibility to vary value added tax rates beyond the constraints imposed by EU law present or future. We note in this respect that it is the European Commission's intention that the new VAT system—including the updated rules in rate-setting—will not take effect before 2022, well after the "two year period" of transition during which the UK would remain in the common VAT area after Brexit.**

2.12 **It is notable, therefore, that the Financial Secretary's Explanatory Memorandum refers to a "mapping exercise" that compares the UK's current zero-rates and other derogations to those that would be allowed under the Commission proposal.**

2.13 **In our view, the Minister's Memorandum implies the Government is operating, even if only provisionally, under the assumption that the UK might still be in the common VAT area when the new rules take effect. This 'mapping exercise' only makes sense if there is a belief in Government that the new VAT rates legislation could apply to the UK, either as a legal obligation or as part of a voluntary approach by the Government to keep UK VAT law broadly in line with the VAT Directive to minimise post-Brexit barriers to trade. If it did not, there would be no risk to any of the current zero-rates or other exemptions, as the Government could decide to maintain, modify or repeal them these irrespective of the restrictions imposed by EU law.**

2.14 **The lack of clarity is part of a pattern. We have repeatedly asked the Government to provide details of its proposals on the UK's post-Brexit relationship with the EU on Value Added Tax, in the context of:**

34 See our Report of 6 December 2017 and the chapter of this Report on the "definitive" VAT system for more information on the Brexit-implications for VAT and trade with the EU.

- **either the trade barriers that arise as a result of leaving the common VAT area for UK businesses which import or export goods and services to or from the EU; or**

- **minimising UK-EU trade friction by remaining in, or aligned with, the single EU VAT area, and the potential constraints continued alignment with the EU's VAT Directive could place on the UK's domestic tax sovereignty—including the ability to vary rates—after Brexit.**

2.15 **To date, we have not received a satisfactory response to these questions. As recently as 19 February, the Financial Secretary told us that he could provide no details about the VAT implications of Brexit for UK businesses because the "arrangements in this regard" will "depend on the outcome of the negotiations", without specifying what the Government's objectives are other than a vague ambition to the most "free and frictionless trade as possible".[35] However, he has not ruled out continued UK alignment with EU VAT law (which the European Parliament also supports).[36]**

2.16 **We also note that the Government, while having rejected the notion that Northern Ireland could remain in a Customs Union and 'shared regulatory area' with the EU, has not commented specifically on the latter's suggestion that Northern Ireland could remain bound by EU VAT and excise law to avoid the need for either side to collect import taxes on the border with Ireland.**

2.17 **In light of these repeated refusals to confirm whether the Government wants to stay in, remain aligned with, or fully exit the single EU VAT area after Brexit, we are left with no option but to conclude that the Treasury is considering seeking some form of continued participation in the EU's VAT system to minimise new frictions in trade with the remaining Member States. In the absence of clear and detailed proposals, however, we cannot be sure to what extent it would require full compliance with the VAT Directive and related legislation (including restrictions on rates), or the possible jurisdiction of the European Court of Justice (considering that VAT is one of the most heavily litigated areas of EU law).**

2.18 **Consequently, we retain the VAT rates proposal under scrutiny and ask the Minister to clarify the following points:**

- **why the Treasury is undertaking its mapping exercise considering the new VAT legislation is not due to take effect until July 2022 at the earliest, well beyond the end of the post-Brexit transitional period if it lasts "around two years";**

- **in particular, whether the mapping exercise is considered necessary because the transitional arrangement might still be in effect by that point; or whether the Government is considering seeking continued participation in the common VAT area and therefore EU VAT legislation; or both;**

35 http://europeanmemoranda.cabinetoffice.gov.uk/files/2018/02/DOC200218–200220181608392.pdf.

36 See motion for a resolution B8–0135/2018 (7 March 2018). The European Parliament "recalls that the UK's current position and red lines would lead to customs checks and verification which would affect global supply chains and manufacturing processes, even if tariff barriers can be avoided; **underlines the importance of a high level of alignment between the Single EU VAT Area and the UK**; believes that taxation matters should be included in any further agreement between the UK and the EU to ensure a maximum level of cooperation between the EU and the UK and its dependent territories in the field of corporate taxation."

- **whether the Government will seek to amend the proposal to revert to 'option 1' as identified by the Commission, namely to maintain the 'positive list' and expand it to make the current country-specific derogations from the VAT Directive available to all Member States;**
- **how, under the new approach proposed by the Commission, the test that a reduced or zero-rate would be "for the benefit of the final consumer" and "be in the general interest", would be applied in practice; and**
- **lastly, to inform us of the outcome of its mapping exercise, and in particular to explain whether the Commission proposal result would be problematic for any existing reduced or zero-rates in the UK.**

2.19 **Given the potential implications of this new EU legislation for businesses, consumers and the Exchequer, we draw the VAT rates proposal to the attention of the Business, Energy & Industrial Strategy and Treasury Committees. We are content to clear the proposed Directive to retain the minimum standard rate at 15 per cent from scrutiny, given the UK's standard rate is well above this at 20 per cent.**

Full details of the documents

(a) Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax: (39448), 5335/18 + ADDs 1–3, COM(18) 20; (b) Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax, with regard to the obligation to respect a minimum standard rate: (39391), 15904/17, COM(17) 783.

Background

2.20 In 1967 the then-six Member States of the European Economic Community (EEC) agreed to replace their national turnover taxes by Value Added Tax (VAT), with the aim of operating a VAT system for cross-border purchases of goods and services in the same way as it would within a single country. This first VAT Directive allowed Member State Governments to set a standard rate at any level they liked, and introduce reduced or increased rates without maximum or minimum limits or restrictions on the types of goods and services to which they could be applied.[37]

2.21 For intra-Community sales of goods, VAT operated as an import tax, paid by the importer to their national customs authorities (i.e. the Member State of the customer) at the border before the goods were released for their use. Similarly, for cross-border supplies of services, the tax was due "where the services provided, the right transferred or granted, or the object hired, is used or enjoyed", which typically meant in the Member State of consumption (given the limited nature of provision of services at a distance at that time).[38]

2.22 For goods, it was the intention—stated as far back as 1967—to achieve a "common market […] whose characteristics are similar to those of a domestic market", requiring the eventual abolition of the system of taxation on importation, by having VAT accrue to the

37 Second Council Directive 67/228/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes—Structure and procedures for application of the common system of value added tax.

38 See Commission document COM(2003) 822.

Member State of the supplier.[39] For cross-border supplies of services, where the question of border controls does not arise, the view was always that taxation of services should take place in the Member State of consumption.[40]

2.23 In 1992, as part of the introduction of the Single Market, the EU Member States agreed to abolish customs inspections on trade in goods between EU countries. While facilitating the free movement of goods, it also meant VAT on cross-border sales of goods could no longer be collected as an import tax by customs authorities. The EU now faced a choice: with the option of collecting VAT for cross-border transactions by customs authorities gone, a new system would have to be created allowing VAT to be collected on cross-border supplies, either in the Member State of the customer ('destination') or supplier ('origin').

2.24 The decision to apply either the 'origin' or 'destination' principle for VAT on cross-border transactions has significant implications for the extent to which Member States can retain flexibility in setting their national VAT rates (which must be the same for domestic and cross-border transactions).

- Under the **'origin' principle**, where VAT on goods would be paid to the tax authorities of the supplier's country at its domestic rate, incentivises customers to buy from businesses in countries with a lower VAT rate.[41] It therefore either requires a level of harmonisation of VAT rates, to prevent a cycle of competitive tax reductions and a revenue shift to the countries with the lowest rates, or a system of redistributing VAT revenues between Member States to prevent countries with higher VAT rates from losing potentially significant amounts of tax revenue.

- Conversely, under the **'destination' principle**, harmonisation of VAT rates is not necessary because customers (whether taxable or non-taxable)—and consequently their suppliers—do not derive any benefit from purchasing goods from a Member State with lower VAT, as they have to pay their domestic rate on the transaction.[42]

2.25 Despite the political difficulties inherent in the 'origin' principle, both the Member States and the European Commission for a long time favoured this system. If implemented, it would be simpler to administer than the 'destination' principle, as the supplier could

39 See recital 1 to the first VAT Directive.

40 See Commission document COM(2003) 822.

41 In a cross-border VAT system based on the 'origin' principle, suppliers apply to intra-EU sales the VAT rate applicable in the country where they are located. This implies an immediate and significant tax advantage for all sales to non-taxable customers (e.g. final consumers or VAT-exempt organisations such as hospitals) located in a higher-rate jurisdiction, who pay VAT in full. Moreover, taxable customers (i.e. businesses) could obtain a cash flow advantage by purchasing supplies from lower rate jurisdictions (but they will not face lower overall costs, as they will have to charge full VAT when they make sales at their domestic rate). As a result, the European Commission says, any significant rate differences under this system would "fatally undermine" the orderly functioning of the Single Market, which relies on the elimination of tax subsidies having a direct impact on cross-border sales.

42 The evaluation of the VAT system carried out in 2011 found that the application of the destination principle to the tax regime for business-to-business (B2B) trade in goods—and since 1 January 2010 for most services—achieved neutrality towards production decisions, and identified some (limited) potential distortions in the areas where the destination principle is not implemented.

account for their VAT liabilities on both domestic and intra-Community transactions to their national tax authority. This was seen as a boost for the free movement of goods and services within the Single Market.[43]

2.26 However, despite their theoretical preference for the 'origin' principle, when faced with the need for a choice between the two approaches as a result of the abolition of customs controls by the end of 1992, the Member States could not agree on a system to make the this system work in practice. They did not want to relinquish their existing flexibility to vary VAT rates,[44] and nor could they agree on a redistributive system to compensate for the substantial amounts of VAT revenue that would shift from the Member States of consumption to the Member States with a larger concentration of suppliers.

2.27 As a result, in anticipation of a future "definitive" VAT system based on the 'origin principle, in 1992 a "transitional" system for goods was adopted that allowed for customs controls on goods to be abolished while VAT would still be collected by the Member State of destination, accounted for by the customer rather than the supplier. To encourage this transition to a "definitive" system, there was pressure for gradual harmonisation of VAT rates that would reduce the scope for VAT-based "tax subsidies":

> "Rate convergence amongst Member States would be encouraged by setting minimum levels for VAT rates and limiting the application of reduced rates. It was hoped that over a period of a few years, Member States would be able to achieve the convergence in rate levels needed to allow the introduction of the planned origin-based definitive system."[45]

2.28 The 1992 "transitional" system did not apply to services, since they are obviously not subject to customs controls. Under the second VAT Directive, the tax was usually paid "where the supplier is located", which in practice usually meant in the Member State of consumption. However, technological change and the drive towards mutual recognition of services providers under new Single Market legislation increasingly allowed services to be provided at a distance from the 1980s onwards. This shifted the associated VAT revenue to the Member State of the supplier. In response, a series of amendments to the VAT Directive were adopted to address this problem over the years and many explicitly required services to be taxed where the customer is located.[46]

43 This followed a policy orientation established already in 1967. See Commission documents COM(87) 321 and COM(92) 5.

44 In 1993, the standard VAT rate already ranged from a low of 15 per cent in Luxembourg to a high of 25 per cent in Denmark. See "VAT rates applied in the Member States of the European Union: situation as at 1st January 2017", p. 18 (accessed 15 February 2018). The UK's standard rate was 10 percent in 1973 and now stands at 20 per cent.

45 To pave the way for the internal market, the Commission proposed to harmonise rates, with a standard rate of minimum 14% and maximum 20% and a reduced rate of minimum 4% and maximum 9% applied to a short list of goods and services (foodstuffs, excluding alcoholic beverages; energy products for heating and lighting; water supplies; pharmaceutical products; books, newspapers and periodicals; passenger transport). It also proposed to abolish all existing derogations.

46 Since 2008, for business-to-business cross-border services, taxation has taken place where the customer is situated, and no longer at the place where the service provider is established. For business-to-consumer services, the place of taxation mostly remained where the supplier is established, as was already the case; however, in certain circumstances (e.g. restaurant services and electronic services like music downloads), taxation of business-to-consumer services would be at the place of consumption in order to prevent distortions of competition between member states operating different VAT rates.

Current rules on VAT rates

2.29 In anticipation of the future introduction of the 'origin' principle for goods, in October 1992 the Council agreed on rules limiting the discretion of individual Member States to set VAT rates they had had until that point.[47] The new VAT Directive required all EU countries to apply a standard VAT rate of a minimum of 15 per cent,[48] and mandatorily exempt certain services from VAT, including insurance and banking services (without a right for businesses engaged in these services to claim a refund for the VAT they paid as input for those services).[49]

2.30 However, the new VAT Directive allowed individual countries to apply a lower rate of VAT—and in some cases no VAT at all—on sales of certain goods or services that would otherwise be subject to the standard rate. These derogations, which still form the basis for the VAT system in force across the EU today, come in two forms.

2.31 Firstly, there is an option for *all* Member States to apply one or two reduced rates, which cannot be lower than 5 per cent, to certain specified goods and services (which are listed in Annex III to the VAT Directive). These include for example most food and drink, pharmaceuticals and medical equipment and broadcasting services. Member States can also apply a reduced rate to only part of a category. Overall, these rules allow Member States to apply a reduced rate, or no VAT at all, to around 65 per cent of household consumption expenditure.

2.32 Secondly, *specific* Member States—primarily those who were already members of the European Community when the internal market was created in 1992—are also allowed, by way of "standstill" derogation, to continue to apply any lower rates, including zero-rates, already in effect before the entry into force of the "transitional", for goods and services not included in Annex III. The types of derogations in this category, which vary by Member State, are:

- **Zero-rated base**: the goods or services are not subject to VAT, but the supplier can get their input VAT refunded (effectively allowing the price to the final consumer to be reduced).[50] This is different from an *exemption* from VAT, where the supplier cannot get their input VAT refunded;[51]
- **Super-reduced rate base**: where a reduced rate *lower* than 5 per cent was applied on goods and services before the new system took effect, Member States could maintain that rate;[52]
- **Parking rate**: where a reduced rate *higher* than 5 five per cent but lower than the minimum standard rate of 15 per cent was in force on goods and services not listed in Annex III, Member States could maintain a lower-than-standard rate (as long as this rate was between must be 12 per cent and 15 per cent).[53]

47 Directive 92/77/EEC.

48 Council Directive 92/77/EEC of 19 October 1992 supplementing the common system of value added tax and amending Directive 77/388/EEC (approximation of VAT rates).

49 Article 135 of Directive 2006/112/EC. However, individual Member States can allow businesses which perform exempt services from opting into paying VAT, so that they can claim a refund for input VAT.

50 The UK has the largest amount of zero-rated goods and services. See below.

51 Exemption from VAT.

52 The super-reduced rate is applied in Ireland, Spain, France, Italy and Luxembourg. See Commission document SWD(2018) 7, p. 85.

53 The parking rate is applied by Belgium, Ireland, Luxembourg, Austria and Portugal. The Commission has said these are "mostly targeted VAT subsidies and often concern B2B supplies".

2.33 The UK and other Member States in 1992 were thus able to "grandfather" their existing lower VAT rates for specific goods and services into the VAT Directive, which they mostly maintain to the present day. Sweden, Austria and Finland were granted similar derogations when they joined the EU in 1995.[54] However, like the other Member States, the UK cannot create new zero-rated or reduced rate categories unless explicitly permitted by the VAT Directive, or by unanimous decision of all Member States.

2.34 The result of this messy political compromise on exemptions from the general rules of the VAT Directive is a patchwork of different tax treatments of similar products and services across Member States, and a significant degree of flexibility for some—but not all—EU countries to apply reduced rates of VAT. However, the objective of these country-specific derogations from the VAT Directive was to allow for national laws to be gradually adapted to harmonised EU-wide VAT rates in anticipation of the introduction of the "origin" principle.[55] Derogations of unlimited duration would therefore expire only when the EU's "definitive" VAT system takes effect.

Use of reduced rates in practice

2.35 In practice, the use of reduced or zero-rates varies very widely between Member States, reflecting national policy priorities,[56] but only a few Member States make significant use of the flexibility to apply reduced rates for specific goods and services granted to them by the existing VAT Directive.

2.36 The Commission has estimated the "rate gap", the difference between each EU country's maximum VAT collection if there was perfect compliance using the reduced rates and exemptions it applies, compared to VAT revenues under perfect compliance if the standard rate was charged uniformly on all goods and services.[57] The UK's "rate gap" is 3.3 per cent, lower than the 5.3 per cent EU average, indicating that it does not make use of the flexibility granted by the VAT Directive to the same extent as other EU countries.

2.37 However, this only takes into account the transactions where it applies VAT. It does not include zero-rated supplies, which are the most substantial derogation in terms of tax revenue because of the greater rate of tax subsidisation of the goods and services covered, and because some zero-rates are applied to very broad categories of good. The UK has a relatively large untaxed base because it can apply zero-rate exemptions to twenty different types of goods and services (including food, drink and children's clothes). In 2000, the latest year for which the Commission was able to cite figures, highest share of zero-rates was in the UK, accounting for about 20 per cent of its theoretical VAT base, followed by Ireland at slightly over 10 per cent.[58]

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54 Countries which acceded to the EU in 2004 were mostly only granted three-year temporary derogations, not open-ended ones as available to 'older' Member States. These expired in 2010, after having been prolonged once.

55 Judgment of 12 June 2008, C-462/05, Commission v Portugal, EU:C:2008:337.

56 This is because, although reduced VAT taxation can help poorer households and can change consumption behaviour in ways perceived to be desirable, from a budgetary viewpoint it is usually an expensive means of doing so, mainly owing to the fact that reduced rates cannot be targeted to specific groups of consumers.

57 https://ec.europa.eu/taxation_customs/sites/taxation/files/2016–09_vat-gap-report_final.pdf, p. 53.

58 Data by Mathis (2004), "VAT indicators: working paper no 2/2004". The Commission added: "While the share of the zero rate in the UK and Ireland should have remained roughly constant, possibly with some erosion due to the lower elasticity to income of many of the goods covered by such rate." The UK applies a zero rate to approximately 20 per cent of all supplies, which is equivalent to 35 per cent of supplies to final consumers who consume 60 per cent of all the supplies for which VAT cannot be deducted.

2.38 Despite the "rate gap", many Member States are not satisfied that the current legislation offers sufficient flexibility with respect to goods and services to which reduced rates cannot currently be applied. The European Commission receives frequent demands for changes to the Directive,[59] usually linked to the fact that goods or services to which a Member State would like to apply a reduced rate are not listed amongst those eligible under Annex III and therefore must be taxed at the standard rate.[60] The Commission has also initiated numerous infringement proceedings against Member States for "unlawfully broad" application of reduced rates, which can generate controversy where the good or service in question affects "primary needs, social or cultural objectives" (such as the UK campaign for reduced rates on women's sanitary products).

Reforming the EU VAT system

2.39 Between 1992 and 2006, the European Commission made several efforts to rationalise the VAT Directive by introducing a maximum standard rate;[61] approximating and subsequently harmonising VAT rates;[62] and, following a comprehensive review, a proposal to abolish the Member State-specific derogations that applied to goods and services not listed in Annex III (i.e. including the UK's zero-rates).[63] However, the Member States could not agree on any of these proposals, and they were subsequently abandoned (although they have on occasion agreed to *extend* the list of services to which a reduced rate can apply).[64] As a result, the requirements and derogations of the 1992 VAT Directive have been maintained mostly unchanged in the current VAT Directive, which was agreed in 2006.[65]

2.40 In parallel to these developments, as we have set out in more detail elsewhere in this Report, the Commission's efforts to introduce a VAT system for intra-EU supplies taxed in the Member State of the supplier had also yielded no results. In 2011, it concluded that a definitive system for VAT on cross-border sales based on the 'origin' principle was "politically unachievable".[66] The Commission therefore said would begin preparing the necessary legislation to permanently base the system on the 'destination' principle instead

59 See SWD(2018) 7, p. 17. This includes a request by the UK for the inclusion of women's sanitary products in the list of goods to which a reduced rate of VAT can be applied.

60 The exhaustive nature of the list of goods and services to which the reduced rates can be applied can, in certain cases, force Member States to breach the fiscal neutrality principle (i.e. that similar goods or services must be subject to the same VAT rate). For example, under Dutch law sunscreen with UVA and UVB filters and toothpaste containing fluoride are pharmaceuticals according to the Dutch Health law, and have to be treated similar to other pharmaceuticals (which are taxed at the reduced rate in the Netherlands). However, Annex III to the VAT Directive does not allow granting a reduced rate to sunscreen and toothpaste. The Dutch Government could therefore either breach the Directive by introducing a reduced rate not permitted, or by increasing VAT on other pharmaceuticals.

61 See Commission document COM(95) 731.

62 See Commission document COM(96) 328, "A common system of VAT" (22 July 1996).

63 Proposal for a Council Directive amending Directive 77/388/EEC as regards reduced rates of value added tax (COM(2003) 397 final).

64 See for example Council Directive 2009/47/EC.

65 Directive 2006/112/EC, as amended.

66 See Commission document COM(2011) 851.

(which would in essence largely reflect the existing situation, as the "transitional" system for intra-EU supplies is already based on accounting for VAT in the Member State of consumption).[67]

2.41 The decision to abandon the transition to the 'origin' principle effectively halted any further attempts to harmonise VAT rates and abolish the existing country-specific derogations, as variable rates are not considered a risk to competition within the Single Market under the 'destination' principle (see paragraphs 2.25 to 2.27).[68]

2.42 In its 2016 VAT Action Plan, the Commission set out the concrete steps it proposed to take to replace the current transitional arrangements for the taxation of trade between Member States by definitive arrangements based on the principle of taxation in the Member State of destination.[69] This would include legislative changes to give individual Member States more flexibility in setting VAT rates, including maintaining all existing reduced rates and derogations and potentially making them available to all Member States. EU Finance Ministers took note of the Commission's VAT Action Plan in May that year. They welcomed the intention to increase flexibility for Member States to apply reduced and zero rates, but stressed that a "sufficient level of harmonisation" of VAT rates "remains required […] to avoid distortion of competition, rise in business costs and negative impact on the functioning of the single market".[70]

2.43 On 4 October 2017 the Commission adopted the first proposal introducing the definitive system for the taxation of trade between Member States, and outlined successive steps and sub-steps for introducing this system, including on VAT rates. In January 2018 this was followed by supplementary proposals on VAT rates, an amendment to the special "SME scheme", and administrative cooperation between tax authorities to tackle VAT fraud.

The Commission proposal on VAT rates

2.44 The European Commission published its proposal to amend the restrictions placed by EU law on Member States in varying their rates of VAT for different goods and services in January 2018. The aim is to address two identified shortcomings of the current approach:

- Firstly, in light of the abandonment of the 'origin' principle, there is no risk to the Single Market of giving individual EU countries the flexibility they seek to apply reduced VAT rates; and
- Secondly, in view of the expiry of the current pre-1992 country-specific derogations from the VAT Directive when the "definitive" system takes effect,

67 The general use of the 'destination' principle for goods notwithstanding, VAT is still levied in the Member State of the supplier for some cross-border transactions within the EU. This is notably the case when non-resident consumers make purchases in another EU country (so that they do not have to declare VAT when they return home); business-to-consumer (B2C) distance sales of goods such as online shopping, where the supplier can apply the origin principle until a value threshold of supplies to a specific EU country in a given year is exceeded; and the special schemes for farmers, travel agents and taxable dealers. With respect to B2C distance sales, the application of the origin principle will be substantially restricted due to [recent changes to EU VAT law], under which the threshold will be significantly reduced, meaning that the destination principle will apply in most cases except for micro-businesses.

68 COM(2011) 851. Its conclusions on the destination system were endorsed by the Council conclusions of 15 May 2012.

69 See Commission document COM(2016) 148.

70 Council conclusions on the VAT action plan and on VAT fraud (25 May 2016).

there is need for new legislation to maintain the current derogations[71] and extend their benefits to all Member States. If the UK were still in the common VAT area when the "definitive" system becomes operational, a possibility which we discuss in more detail below, it would be most affected by the expiry of the derogations because of the extensive zero-rating applied here.[72]

2.45 When considering how to give legal effect to these two complementary aims, the Commission outlined two options:

- **Option 1**: Maintain the current exhaustive list of goods and services to which a reduced rate can be applied in Annex III, but also integrate the existing derogations for specific Member States into the Directive as general exemptions available to all EU countries; or

- **Option 2**: Abolish Annex III and allow Member States to apply reduced rates, including zero-rates, to be applied to any good or service by any Member State, *except* for goods and services to be specifically listed in a new Annex to the Directive (which would, at a minimum, include those identified as having the potential to distort cross-border trade, such as excisable or high-value consumer goods).

2.46 It considered the effects of both options in a number of areas, including the extent to which it would provide Member States with flexibility and treat them equally while preserving tax revenues; limit the potential for tax distortion; and minimise complexity for businesses (and therefore the scope for litigation).

2.47 The Commission concluded that the second option—allowing for full flexibility to apply reduced rates except were specifically precluded by the Directive—was preferable because:[73]

- Creating a 'negative list' for the standard rate and thus permitting the use of reduced rates for all but a pre-defined group of goods and services "provides for general rules to solve the derogations problem", and enables the use of statistical classification[74] to make it easier to define exactly which goods and services are covered (reducing the scope for differential VAT treatment of essentially the same transactions). It also enables the VAT Directive to set a general principle that reduced rates must be "for the benefit of the final consumer", and not the result of specific sectoral interests;

- Conversely, maintaining the 'positive list' and generalising existing country-specific derogations for use by all Member States would "significantly" extend

71 The Member States have made clear to the Commission that they would not accept a proposal to abolish the existing derogations (see SWD(2018) 7, p. 26). In any event, the Commission's own study found the different national VAT treatments have not had a distortive effect for competition in the Single Market under the 'destination' principle that will be made permanent.

72 According to the Commission, if instead of the zero rate a reduced rate of 10 per cent were applied to taxable supplies in the UK, its weighted average rate would increase from approximately 15 to 17 per cent. This, in turn, would increase the Exchequer's VAT revenue would increase by around 14 per cent, equivalent to approximately £18 billion a year.

73 Commission Impact Assessment SWD(2018) 7, p. 58–59.

74 CPA is the 'statistical classification of products by activity'.

"an already excessive and unstructured list of good and services to which reduced VAT rates can be applied", meaning that "conflicts with the principle of fiscal neutrality [would be] likely to increase".

Details of the Commission proposal

2.48 Following the publication of its proposal on the full shift to the "destination principle" for cross-border business-to-business transactions within the EU in October 2017, the Commission in January 2018 issued further proposals on giving individual EU countries more flexibility to vary their VAT rates and to put existing exemptions on a permanent footing (but extended to all Member States).

2.49 The details of the Commission proposal are as follows:

- The minimum standard rate of VAT of 15 per cent would be maintained indefinitely,[75] but a new Annex IIIa would be created within the VAT Directive. This would list exhaustively the goods and services to which the standard rate *must* be applied, and from which no derogation is permitted;
- The contents of this 'negative list' would be based on an assessment of whether the application of a reduced rate or exemption from VAT "could lead to distortion of competition". The Commission has produced a draft list,[76] which includes transactions identified as having the potential to distort competition without a harmonised VAT approach, namely excise goods such as tobacco and alcohol, high-value items that are easily transportable like jewellery, and exempted services for which Member States can, optionally, allow individual companies to deduct input VAT and pay output VAT (such as financial services);[77]
- In addition, the Commission has also proposed the inclusion on the 'negative list' of "certain additional goods for which some risk of distortion could be feared in a fully liberalised rates regime", because of potential cross-border shopping (e.g. expensive but easily-transported consumer goods such as computers, electronic and optical products, watches, musical instruments, electrical equipment and furniture);
- For goods and services not listed in the new Annex, Member States would be free to apply one or two reduced rates between 5 and 15 per cent; one super-reduced rate between 0.1 and 5 per cent; and a zero-rate.[78] However, these would have to

75 The maintenance of the 15 per cent minimum standard rate of VAT is contained in a separate legislative proposal which the Commission hopes will be adopted expeditiously, as the current requirement expired on 31 December 2017. However, the Commission notes that this is primarily for reasons of legal certainty, as "all Member States levy standard rates that are well above the 15% threshold, and it seems highly unlikely that in the foreseeable future any Member State would wish to cut the standard rate below 15%".

76 The draft "standard rates" list is available in the Annex to Commission document COM(2018) 20.

77 Sales of financial services, including insurance, are mandatorily exempt from value added tax under the Directive. However, they are not zero-rated. This means that financial services providers cannot get a refund of their input VAT (i.e. the VAT they pay on the services and goods they buy to provide financial services). The European Commission tabled a proposal in 2007 to address the resulting legal uncertainty and administrative burden on businesses, but it was withdrawn in 2016 after negotiations stalled in the Council. Recently, the Bulgarian Presidency of the Council has been facilitating renewed high-level discussions on this matter, but no legislative proposal is currently foreseen by the Commission.

78 The Commission notes that, under its draft list of standard rate goods and services, some existing derogations would have to be abolished: in three Member States this relates to a reduced rate for wine, and in one Member State to a reduced rate for short-term hire of means of transport.

be "for the benefit of the final consumer[79] and must be in the general interest", and as such any goods or services that "can be used only as an intermediate input" would not qualify for a reduced or zero-rate;[80] and

- The overall system would be subject to a "revenue safeguard" in each Member State, which would require Governments to ensure that they apply a weighted average VAT to taxable transactions within their territory that exceeds 12 per cent.[81] This is to ensure that those Member States with the lowest VAT rates cannot substantially lower them further, and thereby prevent erosion of the VAT base, and to ensure budgetary stability given the importance of VAT as a revenue source for all Member States.

2.50 Although EU Finance Ministers declined to indicate their preference between the options in their Council conclusion on VAT in May 2016, at technical level Member States have "preferred the more conservative option" (i.e. maintaining the 'positive list' and extending country-specific derogations to all Member States) as national Governments saw the need "for the VAT system to maintain a sufficient level of harmonisation".[82]

2.51 While the Commission proposal is being discussed in the Council, the Commission has said that it will continue to conduct regular reviews of Annex III—the goods and services to which the reduced rate can currently be applied—in consultation with the Member States in its VAT Committee, to make sure "its wording is clear and not obsolete, and its contents are in line with technological developments and social and political needs". The Commission would then table a legislative proposal to adapt the Annex as and when needed until the new system took effect.

The Government's view

2.52 The Financial Secretary to the Treasury (Mel Stride) submitted an Explanatory Memorandum on the VAT rates proposal on 8 February 2018.[83]

2.53 The Minister expressed the Government's support for the Commission's intention to substantially increase the scope of goods and services eligible for reduced rates, and indeed the flexibility for Member States to apply a zero-rate to such supplies, to "suit their domestic circumstances and needs". The Minister noted in particular that the proposed changes would mean Member States would have the ability to apply a zero-rate of VAT to women's sanitary products, a flexibility which has long been sought by the UK Government.[84]

79 The 'final consumer' is the person who acquires goods or services for personal use, as opposed to an economic activity, and thus bears the tax.

80 The Commission notes that the new rules on VAT rating would "not exclude the use to goods or services that are used as intermediate input if those are goods or services typically sold to final consumers".

81 The weighted average VAT rate in a Member State would take into account all VAT rates in force. Each VAT rate would be weighted with the share of the value of the transactions to which that rate applies as a percentage of the total of taxable transactions.

82 Council conclusions of 25 May 2016.

83 Explanatory Memorandum submitted by HM Treasury (8 February 2018).

84 At present, only Ireland can zero-rate women's sanitary products, as it already applied this rate on 1 January 1991 and this was consequently 'grandfathered' into the post-1992 VAT Directive.

2.54 In relation to the revenue safeguard proposal, the Minister notes that the UK's weighted average of VAT on taxable transactions rose well above the envisaged 12 per cent floor when the Government increased the standard rate of VAT to 20 per cent in 2011. As such, he added, "the proposed level does not cause immediate concerns in relation to the UK's current use of standard, reduced and zero rates".

2.55 While it is not clear whether the Government would have preferred the Commission to select the "more conservative" option of retaining and extending the 'positive list' to which reduced rates can be applied, the Minister does express a note of caution with respect to the proposed replacement of the current country-specific—including the UK's ability to zero-rate a wide range of goods and services—with a general right to apply reduced rates except for transactions listed on the new 'negative list'. The Minister notes that there is some uncertainty as to whether none of the goods or services currently subject to a reduced or zero-rate in the UK are excluded from proposed 'negative list'. If any of the current derogations were included in the new Annex IIIa, the standard rate of 15 per cent would have to be applied.

2.56 It is curious that, in this context, the Minister does not refer to the implications of the UK's exit from the EU for its domestic VAT regime in any substantive way. In principle, the UK will cease to be bound by the Directive, and any constraints it places on setting of VAT rates, when EU law ceases to apply. In practice, this is expected to be at the end of the post-Brexit transitional period the Government is currently negotiating with the EU. The other Member States have set an indicative end date of 31 December 2020 and the Government wants to negotiate a longer (but "strictly limited") period of "around two years" from March 2019.

2.57 Given that the Commission proposal explicitly notes that the new VAT rates system would not take effect until 2022 at the earliest, it is striking that the Minister does not indicate the proposal would not have a direct impact on the UK. Indeed, the Explanatory Memorandum actively indicates that Government believes the UK may be covered by the EU's VAT rules well into the next decade:

> "The Government has (…) begun a mapping exercise in order to identify how the categories [compulsorily subject to the standard rate] and the intended classification of products by activity codes, align with the UK's existing zero and reduced VAT rates.
>
> As a proposal intended to grant Member States greater flexibility in the setting of their domestic VAT rates, it is important that full consideration is given to aspects of the proposed changes which may result in the inadvertent loss of Member State autonomy in this respect. It is unlikely that Member States will be willing to agree to any changes that force them to remove or amend their existing reduced and zero rates."

2.58 This 'mapping exercise' only makes sense if there is a belief in Government that the new VAT rates legislation could apply to the UK. If it did not, there would be no risk to any of the current zero-rates or other exemptions, as the Government could decide to maintain, modify or repeal them these irrespective of the restrictions imposed by EU law. That indicates that either the Government believes the transition may last well into 2022,

or that it is considering seeking continued participation in the EU's common VAT area afterwards to minimise new trade friction arising from VAT being charged as an import tax on goods flowing between the UK and the EU after Brexit (or, potentially, both).

2.59 However, the former of these possible explanations for the Treasury's apparent presumption that the VAT rates proposal may apply in the UK (namely that the transitional arrangement might still be in effect by 2022) contrasts with the position the Government has taken on other EU proposals which are expected to take effect after December 2020. For example, with respect to the next Multiannual Financial Framework—the EU's next long-term budget—the Chief Secretary to the Treasury told us it was "not relevant to the UK". Similarly, the DEFRA informed the Committee that the next Common Agricultural Policy—also due to take effect in 2021—"will not apply to the UK".

2.60 Therefore, it appears the Government is considering continued participation in the EU common VAT area indefinitely, most likely requiring adherence to the VAT Directive and supplementary legislation. We have explored the Brexit implications of this proposal, and for the UK's VAT regime more generally, in the "Summary and conclusions" section above.

Previous Committee Reports

None.

3 VAT: exemptions for small businesses

Committee's assessment	Politically important
Committee's decision	Not cleared from scrutiny; further information requested; drawn to the attention of the Business Energy and Industrial Strategy and Treasury Committees
Document details	Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax as regards the special scheme for small enterprises
Legal base	Article 113 TFEU; special legislative procedure; unanimity
Department	Treasury
Document Number	(39449), 5334/18 + ADD1–3, COM(18) 21

Summary and Committee's conclusions

3.1 The European Union forms a Single EU VAT Area, where each Member State is required to levy value added tax on supplies and goods of services. Uniquely, within this area VAT on imports of goods between EU Member States are not collected by customs officers at the border.[85] To enable this system to work, EU VAT law imposes significant 'behind the border' administrative burdens on businesses, which are responsible for collecting the tax and paying it to the relevant tax authority. For small businesses in particular, VAT compliance costs can be significant.

3.2 To mitigate these costs, the EU VAT Directive[86] contains several provisions designed to ease the burden on small businesses dealing with value added tax, which are collectively known as the "SME scheme".[87] In particular, individual EU countries can use the "SME exemption", which allows them to exempt smaller businesses based domestically from charging VAT to their customers[88] if their annual turnover is below a specific threshold,[89] and apply various simplification regimes aimed at small businesses to reduce overall VAT-related administrative burdens.

3.3 The current legal framework has resulted in a patchwork of different approaches to simplifying the VAT system for small businesses between EU Member States, and is seen as a barrier to trade and growth.

- Firstly, the VAT exemption threshold does not apply to businesses seeking to supply goods or services to a consumer in another Member State,[90] meaning

85 Outside of the EU (including for imports of goods from third countries into the EU), VAT is an import tax collected (or checked and deferred) at the border following customs controls.

86 Directive 2006/112/EC, as amended.

87 See Chapter 1 of Chapter XII of Directive 2006/112/EC.

88 Consequently, small companies which do not charge VAT can also not deduct their input VAT. They are effectively treated as a final consumer.

89 See SME exemption threshold varies by EU country (see "Background" below). In the UK it is £85,000, the highest of any Member State.

90 Intra-EU business-to-business supplies are generally zero-rated given the abolition of customs controls, after which the business customer accounts for the VAT due to their domestic tax authority under the reverse charge mechanism. See our Report of 6 December 2017 on the Single EU VAT Area for more information, and how the Commission has proposed changing this system.

SMEs seeking to engage in cross-border trade would have to account for VAT under that country's domestic rules for any sales, irrespective of their turnover (a requirement that would not apply to an otherwise identical business based in that country, given domestic firms a competitive advantage).

- Secondly, at domestic level, the VAT exemption for small businesses incentivises companies to remain below the turnover threshold to avoid becoming subject to additional administrative requirements relating to VAT.[91]

3.4 To address these issues, the European Commission presented a legislative proposal in January 2018 to amend the SME-specific provisions of the VAT Directive (as part of a wider process of reform of the Single EU VAT Area).[92] The main elements of its proposal, which we have set out in more detail in paragraph 3.32 to 3.42 below, are to:

- remove the current country-specific restrictions on the VAT threshold for SMEs, and instead permit all Member States to vary the SME exemption threshold below a maximum of €85,000 (£75,000),[93] including the possibility of different thresholds for different sectors;
- enable small businesses from *any* EU country which meet the relevant turnover requirements—namely the domestic SME exemption threshold in the Member State where the good or service is supplied, plus an EU-wide turnover limit of €100,000 (£88,000)—to make use of the SME exemption when selling to consumers in any other Member State;[94]
- establish a transitional relief mechanism, allowing small businesses that temporarily exceed the VAT exemption threshold in a given Member State to remain covered by the exemption under certain conditions; and
- introduce further simplifications to the VAT obligations for small businesses with a turnover of €2 million (£1.8 million), whether or not they can avail themselves of the SME exemption.

3.5 The Commission wants these changes to take effect alongside the wider reforms of the EU's VAT system in summer 2022. However, that timetable will depend on the progress made by the EU's national governments on the proposals: under the Treaties, each Member State has a veto over new European tax legislation.

3.6 The Financial Secretary to the Treasury (Mel Stride) submitted an Explanatory Memorandum on the proposal for a revised VAT scheme for small businesses in February

91 This so-called 'threshold effect' is particularly pronounced in the UK, because it operates a VAT threshold at a much higher level than any other Member State.

92 The European Commission set out the scale of its proposed reforms in its 2016 VAT Action Plan. In addition to the SME-specific amendments, it also includes separate legislative proposals on the way in which VAT is accounted for on business-to-business transactions between Member States; the flexibility of individual EU countries to vary their VAT rates; and the level of administrative cooperation between the EU's national tax authorities to tackle VAT fraud and evasion. We have discussed these other proposals separately in the other chapters of this Report.

93 €1 = £0.88415 or £1 = €1.13103 as at 28 February.

94 In most cases under EU VAT law, value added tax must be paid in the Member State of consumption. However, for cross-border business-to-business supplies of goods and services within the EU, the VAT must be accounted for by the customer and not the supplier (for reasons explained in our Report on VAT of 6 December 2017). Therefore, the extension of the SME exception would primarily benefit small businesses seeking to sell goods or services to consumers in other Member States.

2018.[95] In it, he welcomed the Commission's aim of "[reducing] the burden placed on SMEs by the administration of VAT and that lessens any VAT threshold-related distortions", including the extension of the SME exemption to small businesses from other EU countries.

3.7 However, the Minister also identified a number of areas of concern or which require further clarification, in particular with respect to the interaction between the Government's own work on reform of the UK VAT threshold—on which the Treasury launched a consultation in March 2018[96]—and the Commission proposals for a new maximum VAT exemption threshold and the transitional relief mechanism where the threshold is exceeded. With respect to the implications of Brexit for the UK's VAT regime and its participation in the single EU VAT area, the Financial Secretary's Explanatory Memorandum is silent.

3.8 **The Committee currently has under scrutiny a number of important VAT-related legislative proposals tabled by the European Commission since autumn 2017. We have taken note of the proposal to simplify the VAT obligations for small businesses, and to remove VAT-related barriers to cross-border trade within the European Union. Compared to the other elements of the VAT reform package, the changes are less drastic but could nonetheless have a major impact on individual small firms.**

3.9 **Although the proposals are driven by the need to make it easier for small businesses to trade across borders within the EU without being hampered by different national VAT systems, they would necessarily also have a domestic impact. In the UK, should EU VAT law apply despite Brexit (see below), the most significant changes resulting from the proposed changes to the SME scheme would be:**

- **a reduction in the VAT threshold for small businesses from £85,000 to £75,000 (the new maximum);**
- **the removal of the Treasury's ability to increase that threshold to maintain its real value over time, and protect it from erosion by inflation;**
- **the ability for small businesses from elsewhere in the EU to sell goods or services to UK consumers without having to charge VAT (i.e. under the same condition as domestic SMEs); and**
- **the need for changes to existing VAT rules, in particular as regards invoicing and interim payments of VAT, and a new obligation for HM Revenue and Customs to collect information on the turnover of UK SMEs on their sales across the entire EU.**

3.10 **As the Minister has rightly noted, these proposals cut across the Government's own work on the UK's VAT threshold following a review by the Office for Tax Simplification in 2017. However, any changes to the VAT Directive would, of course, only have a direct impact on the UK were it still subject to EU VAT law when they take effect. If it were not, the Government would be free to vary the VAT threshold; to apply the SME exemption to UK businesses only; and to structure invoicing and reporting requirements as it sees fit. Conversely, of course, UK businesses would not be able to use the SME exemption when selling to consumers in the EU-27.**

95 Explanatory Memorandum submitted by HM Treasury (8 February 2018).
96 See https://www.gov.uk/government/consultations/vat-registration-threshold-call-for-evidence.

3.11 **More generally, as we have stated repeatedly, the UK's exit from the Single EU VAT Area would mean that exports of goods from the UK to the EU and vice versa would be subject to physical custom controls to ensure the correct amount of VAT is paid (in contrast to the current situation, where there are no such controls and movements of goods are monitored via the EU's VAT Information Exchange System).[97] This will make UK suppliers less attractive to EU customers (and vice versa), while also presenting cash flow issues for businesses which can currently pay VAT on cross-border purchases after they have already taken possession of their imports.**

3.12 **However, whether or not the UK will still be bound by EU VAT law when the European Commission's VAT reform proposals are due to take effect in 2022 remains unclear. Consequently, we also do not know whether the Commission's SME proposal will in fact restrain the Government's room for manoeuvre if it wanted to amend the VAT threshold, or other aspects of UK VAT law.**

3.13 **We note in this respect that the Minister's Explanatory Memorandum on the proposal assumes the new EU legislation on VAT obligations for SMEs may apply in the UK, as demonstrated by the fact that the Government is concerned the Commission proposals could "interact" with its own review of the UK VAT threshold. The same implicit acceptance that the Treasury may have to continue to apply the VAT Directive, including the slew of amendments proposed in recent months by the Commission, is also present in the Minister's Memoranda on the other proposals we consider elsewhere in this Report.**

3.14 **In our view, there are three possible reasons why this might be the case.**

- **Firstly, although the two-year Article 50 period in principle fixes the UK's exit date for 29 March 2019,[98] the Government is seeking a subsequent stand-still transitional period during which the UK would stay in the Single EU VAT Area. It has been agreed that this period should end on 31 December 2020, but an extension cannot currently be ruled out.**

- **The second explanation for the implicit assumption that the writ of the VAT Directive will still run in the UK by 2022 is the possibility of a post-Brexit UK-EU agreement on value added tax which essentially replicates the Government's current obligations.[99] This would obviate the need for VAT controls at the border, but most likely require continued adherence by the UK's to the EU's harmonised VAT legislation (without a formal say over any future changes); or**

- **Lastly, the Government may be prepared to minimise VAT-related friction in trade with the EU by voluntarily aligning UK law with the EU VAT Directive in specific areas (such as the SME scheme) to effectively arrive at the same outcomes, but by different means and without a legal obligation for the UK to transpose future changes to the Directive. Under those circumstances, it**

97 See https://ec.europa.eu/taxation_customs/individuals/buying-goods-services-online-personal-use_en. Supplies of services to businesses are subject to different rules (as they must typically account for the VAT themselves, rather than the non-EU supplier).

98 The UK's formal exit date could be different if the Government requested an extension of the Article 50 period, or if the Withdrawal Agreement specifies a different date.

99 For example, both the Isle of Man and Monaco are within the Single EU VAT Area despite not being part of the EU. However, in both cases this is because of their close association with an EU Member State.

would also be important for the Government to assess the implications of the Commission's proposals, to inform any future decision on voluntary adherence. To what extent this would actually facilitate trade, given the important roles for a harmonised legal framework backed up by the powers of the EU institutions to enable the current intra-EU system to work without border controls, is unclear.

3.15 **The Government has not made clear which of these reasons lies behind its assumption that reforms to the EU's VAT system may apply in the UK from 2022 onwards. It should urgently clarify its intentions in this area, considering the significant implications for UK businesses of an exit from the Single EU VAT Area (in terms of increased domestic flexibility, at the expense of easier access to the EU market).**

3.16 **Moreover, if the UK were to remain subject to the substance of EU VAT law beyond 2021, this raises serious concerns about the Government's loss of veto over tax-related EU proposals on 29 March 2019. There is clearly a possibility that some or all of the Commission's wider VAT reform package could be formally endorsed by the Council after March 2019, when the UK would be unable to block them, while the Government could nevertheless be under an obligation to implement them.**

3.17 **Given the substantial impact these proposals could have in the UK, and in view of the considerably uncertainty about the future of the relationship between European and British VAT law, we retain the document under scrutiny. We also draw it to the attention of the Business, Energy & Industrial Strategy and Treasury Committees.**

Full details of the documents

Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax as regards the special scheme for small enterprises: (39449), 5334/18, COM(2018) 21.

Background

3.18 The EU Value Added Tax Directive (Directive 2006/112/EC) requires all Member States to collect value added tax (VAT) on supplies of goods and services. As a consumption tax, its costs are borne ultimately by the final consumer, but—as an indirect tax—the revenues are collected by businesses that make those supplies.

3.19 Under the EU VAT system, businesses supplying goods or services collect the VAT paid by the consumer, while being able to deduct from the VAT they have collected the amount of tax they have paid to other suppliers on purchases for their business activities. The difference between VAT collected from consumers (output VAT) and VAT paid to other suppliers (input VAT) is the VAT due to the tax authorities. The resulting "fractionated" system spreads payment of the tax throughout supply chains, in some ways making it self-policing as a business has an interest in ensuring their customer pays VAT because they have had to do the same when purchasing their own supplies.

3.20 As a result of businesses having to collect VAT, the EU law places them under a number of administrative obligations which aim at ensuring a correct functioning of the system. These obligations can be summarised as follows:

VAT obligation	Description
Registration	Registration with the VAT authority of the Member State where VAT must be paid (typically where the customer is based)[100]
Invoicing	Issuing invoices to customers showing VAT paid
Recordkeeping	Keeping accounts in sufficient detail for VAT to be applied and its application checked by the tax authorities
VAT returns	Preparing and submitting periodical VAT returns and recapitulative statements
Payment	Periodic payment of VAT to the appropriate tax authority

Source: European Commission

3.21 The compliance burden of meeting these obligations generates a significant cost for businesses. VAT obligations are particularly burdensome for small businesses, given that they have more limited resources than large businesses. This leads to small businesses bearing proportionally higher VAT compliance costs than larger businesses relative to their size. In recognition of this higher burden, and the barrier it can pose to the development of successful new businesses, the VAT Directive contains several provisions designed to ease the burden on SMEs dealing with VAT.[101]

3.22 The SME scheme allow Member States to:

- provide for simplified procedures for charging and collecting VAT, as long as these do not lead to a reduction of the tax due. Examples of such simplified procedures are flat-rate schemes,[102] graduated relief,[103] or cash accounting schemes;[104] and
- apply the "SME exemption" to businesses (but only those established in the Member State in question) which have an annual turnover below a certain threshold. Businesses within scope are exempt from charging output VAT and deducting input VAT. Effectively, they are treated as a final consumer, even though they are not. In the UK, this threshold currently stands at £85,000[105] (the highest in the EU by far).[106]

100 As we have discussed elsewhere in this Report, the payment of VAT on cross-border transactions within the EU can, under certain circumstances, be made to the tax authority of the country where the supplier is based (e.g. for distance sales of goods to consumers below a value threshold). In addition, the EU has a "Mini One Stop Shop" system for providers of certain electronic services to consumers which allows them to account for VAT to their national tax authority, which then remits it to the tax authority of the consumer's Member State.

101 See Chapter 1 of Chapter XII of Directive 2006/112/EC.

102 Under flat rate schemes, the business does not have to precisely calculate the difference between their input and output VAT and make up the difference to their tax authority. Instead, they can apply a fixed flat-rate percentage to their gross turnover to arrive at the VAT due.

103 Under graduated relief, the amount of VAT to be collected by a small business increases gradually as the business turnover increases beyond certain thresholds.

104 Cash accounting schemes aim to improve the cash-flow of small businesses by allowing them account for the VAT charged (output VAT) only when they have received payment from their customers (rather than at the point at which a supply is actually made, even if payment is not yet received), and deduct the VAT paid (input VAT) only once the purchases have been paid for. For example, under the UK's cash accounting scheme, small businesses can pay VAT on their sales when they are paid by their customers, and reclaim VAT on your purchases when you have paid your supplier.

105 Under the VAT Directive, the UK (and certain other Member States) can only increase this threshold to maintain its value in real terms as it was in 1977.

106 See European Commission, "VAT thresholds April 2017" (accessed 9 March 2018). Ireland is the only other Member State to have a VAT registration threshold above €50,000 (the UK's, converted to euros, currently amounts to €95,000). The Netherlands and Spain are the only Member States not to use the SME exemption.

3.23 In addition, there are SME-specific derogations and exemptions available that are not, in a legal sense, part of the "SME scheme" under the VAT Directive but based on other provisions of the same Directive. These can affect the obligations for businesses in different ways in different Member States, for example as relates to rules on invoicing, accounting or reporting of VAT.

The need for reform

3.24 The current legal framework has created a patchwork of different approaches to simplifying the VAT system for small businesses, which varies considerably from one Member State to another. This, in itself, poses a barrier to cross-border trade within the Single Market: as VAT on business-to-consumer sales must normally be accounted for by the supplier in the country of the customer, businesses have to be familiar with potentially multiple different national VAT systems. Overall, the European Commission says:

> "the fact that all of these measures are scattered throughout the VAT Directive increases the complexity of the current rules. Moreover, they are conceived as measures independent from each other rather than as a full simplification regime for small enterprises, which affects the overall effectiveness of the SME scheme."[107]

3.25 The current SME scheme in the VAT Directive has, in the Commission's view, created two main problems that need to be addressed.

3.26 Firstly, the SME exemption only benefits domestic and not intra-EU trade. This is because small businesses can benefit from the SME exemption from collecting VAT (see above) only in the Member State where they are established. As such, given that under EU law VAT must normally be paid in the country of the customer, any businesses seeking to supply to another EU country would have to pay VAT there, under the locally-applicable rules.

3.27 Overall, this puts small businesses (which are unlikely to have the necessary resources to comply with two or more sets of VAT rules) seeking to expand across the EU at a competitive disadvantage in two ways:

- domestic small companies in the target market benefit from their national SME exemption, and therefore face fewer or no VAT requirements on the supply of the same goods or services than the SME from another Member State would; and
- large companies seeking to enter new EU markets are more likely to have the resources to meet the necessary administrative requirements of complying with a new set of VAT rules.

3.28 The potential burden of having to comply with VAT rules in another EU country when wanting to sell goods or services there is potentially significant, because of the complexity and diversity of legislation on VAT obligations across the EU.[108] As a result,

107 https://ec.europa.eu/taxation_customs/sites/taxation/files/18012018_impactassessment_vat_smes_en.pdf, p. 16.

108 For example, there are thresholds on the distance sale of goods to another EU country below which a business can pay VAT domestically and above which the VAT must be paid in the country of the customer. These thresholds can vary by Member State and can require a small business to register for VAT in another country.

the Commission says, "discourages SMEs from exploiting the opportunities offered by the Single Market by increasing the costs of border-crossing trade flows relative to domestic sales".

3.29 In 2015, the EU introduced a simplified registration and payment system MOSS (Mini One Stop Shop) to address these problems for small businesses supplying electronic services to final consumers (B2C). The MOSS allows a business to make their VAT payments on a cross-border sale to their domestic tax authority at the rate of the Member State of the customer, after which the revenue is remitted to the latter's tax authority.[109] Under recently-agreed reforms, the MOSS systems is due to be expanded to all cross-border business-to-consumer sales in the EU from January 2021.[110] However, these represent only a small fraction of intra-EU transactions that attract VAT, as the vast majority concerns business-to-business sales.[111]

3.30 Secondly, at domestic level, the SME exemption creates the "threshold effect", incentivising small businesses to limit their growth to avoid crossing the turnover threshold and becoming subject to the full obligations of the VAT Directive. This effect has been most pronounced in the UK, because of its high threshold. In November 2017, the Office for Tax Simplification within the Treasury reported:[112]

> "The data and anecdotal evidence considered (…) clearly shows that the threshold distorts behaviour by creating a significant cliff-edge, resulting in a bunching effect just below the £85,000 turnover level, rather than the smoother pattern one would otherwise expect. The threshold is therefore presenting a significant disincentive to maximising the potential growth of some businesses and, considering the numbers involved, this is likely to adversely impact economic growth.
>
> This problem appears more acute in the UK than in other EU countries because of the high level of the UK registration threshold. Indeed, the OTS has often been told that some businesses take steps to reduce the level of their business activity to avoid crossing the threshold."

3.31 The European Commission published a VAT Action Plan in 2016. Among a raft of other reforms, including changes to the taxation of cross-border sales, the restrictions on VAT rates and administrative cooperation between tax authorities,[113] the Commission also announced that it would prepare a "comprehensive simplification package for SMEs that will seek to create an environment that is conducive to their growth and favourable to cross-border trade" to address the issues described above.

109 Under MOSS, the business still has to comply with certain rules of the Member State of consumption (for example related to invoicing), but it does not have to register for VAT purposes in that country.

110 See our Report of 24 January 2018.

111 As part of the 'definitive' system of VAT, the European Commission has suggested expanding the MOSS to all intra-EU sales, although this is likely to be controversial as it shifts responsibility for VAT collection to a large degree to 'supplier' Member States like Germany. See our Report of 6 December 2017.

112 Office for Tax Simplification, "Value added tax: routes to simplification" (November 2017).

113 We have covered the other three elements of the VAT reform package in other chapters in this Report.

The Commission proposal

3.32 In January 2018 the Commission tabled the amendment to the VAT Directive on obligations for small businesses as it had announced in its Action Plan two years earlier. The main elements of its proposal are to:

- remove the current country-specific restrictions on the VAT threshold for SMEs, and instead permit all Member States to vary the SME exemption threshold below a maximum of EUR 85,000 (£75,000), including the possibility of different thresholds for different sectors;
- enable small businesses from any EU country, when selling to consumers in another Member State, to make use of the latter's SME exemption on the same terms as its domestic businesses (provided they meet the relevant turnover requirements to qualify as a small business);
- establish a transitional relief mechanism during which small businesses that temporarily exceed the VAT exemption threshold in a given Member State will be able to continue to be exempt; and
- introduce further simplifications to the VAT obligations for small businesses (whether or not they can avail themselves of the SME exemption).

3.33 We have described these aspects of the proposed new SME scheme individually below.

Reforming and extending the SME exemption

3.34 The Commission proposal would make substantial changes to the existing limitations on the SME exemption (i.e. the turnover threshold below which a company does not have to charge output VAT or account for input VAT). Currently, the 26 Member States[114] which use the SME exemption fall into two categories:

- countries which joined the European Economic Community before 1977[115] are bound by a "stand-still" provision, which allows them to maintain the real value of their national threshold in that year by increasing it to reflect the effects of inflation; and
- countries that joined the Community or the EU after 1977 must observe a fixed threshold (without the opportunity to increase it to reflect inflation).

3.35 Under the Commission proposal, these country-specific restrictions and thresholds would be abolished. Instead, Member States would be allowed to vary their own national VAT threshold at will, up to a new common upper limit of €85,000 (£75,415). The proposal also allows for varying the threshold for VAT registration for different business sectors based on "objective criteria". The flexibility for the pre-1977 Member States to continually adjust their domestic threshold to maintain its real value will be removed (although none except Ireland and the UK operate thresholds near or in excess of the proposed maximum in any event).

114 Spain and the Netherlands do not operate the SME exemption.
115 I.e. Germany, France, Italy, Belgium, Luxembourg, the Netherlands, the UK, Denmark and Ireland.

Addressing the threshold effect: transitional relief

3.36 The Commission has proposed to tackle the phenomenon of SMEs restricting their activities to remain under their domestic VAT threshold. Under the new scheme, small businesses would be allowed to continue to benefit from the SME exemption in a given Member State even if their turnover exceeded the relevant national threshold by 50 per cent or less during a single calendar year. For example, in a Member State where the threshold is €40,000, a business would not be required to register in the first calendar year in which they exceed the threshold, providing in that calendar year their turnover remains at or below €60,000. In any subsequent year, if the turnover exceeds the domestic threshold (by any amount), the company would no longer be able to benefit from the VAT exemption.

3.37 In parallel, the Commission proposes to abolish existing graduated relief schemes for VAT (operated in Spain, the Netherlands, and Finland), under which the amount of VAT to be collected by a business is reduced depending on its turnover, with the relief gradually decreasing with the increase of turnover.[116] The Commission believes these schemes can be eliminated because they were found to be "a source of complexity and contributes little to reducing the compliance burden of small enterprises". The abolition of graduated relief itself will have no impact in the UK as it does not currently apply such a scheme.

Extending the SME exemption to non-domestic businesses

3.38 The proposal would amend article 283 of the VAT Directive, requiring Member States to apply the SME exemption from VAT registration not only to their domestic businesses, but also to "non-established enterprises" (i.e. small businesses based in another EU country).[117] To benefit from the SME exemption when selling into another EU Member State, the business in question must have a turnover below the relevant domestic threshold in that country.

3.39 In addition, an SME seeking to avail itself of the VAT exemption in another EU country would have to have a turnover across the entire European Union not exceeding €100,000 (£88,723). This "Union turnover" restriction is aimed at preventing larger companies from benefiting from the SME exemption in numerous Member States (i.e. if their turnover in each Member State were below the applicable SME exemption threshold, but its collective turnover plainly put it beyond the category of a 'small business'). The domestic authorities of the EU country where the SME is established would have to "collect all relevant information on its turnover" and "inform the tax authorities of the other Member States concerned in which the small enterprise carries out its supplies".

116 The graduated relief scheme are in effect a variation of the SME exemption, in the sense that they also relieve small enterprises of the burden of collecting tax, although this is done gradually by means of multiple thresholds. Like the SME exemption, the graduated relief is available only to domestic businesses, and the thresholds under which the exemption applies are determined in relation to the annual turnover of the business.

117 Non-EU businesses that sell into the EU would not be able to make use of the SME exemption as they are outside the single VAT area.

Simplified VAT obligations for both exempt and non-exempt small enterprises

3.40 Lastly, the Commission proposal would rationalise the structure of the VAT Directive by incorporating various simplified obligations (registration, invoicing, keeping of accounts and VAT returns) for exempt enterprises explicitly into the exemption scheme, rather than having them "scattered" throughout the legislation.

3.41 As part of this process, the Commission also wants to create a new set of simplified obligations for small enterprises that do not benefit from the SME exemption (for example, those eligible for exemption but opting for taxation on the basis of the general rules to allow them to deduct input VAT,[118] or those with turnover above the exemption threshold that applies in their market). To target these simplification measures, the Commission proposes to create a new definition for 'small enterprises', namely those with a turnover lower than €2 million (£1.8 million).

3.42 For business in this category (including those covered by the SME exemption, insofar that does not negate the need for other VAT-related administrative requirements in their Member State),[119] each EU country would also have to implement a set of simplified VAT obligations for small enterprises, including:

- introducing obligations relating to the **storage of invoices** by small enterprises;
- allowing all SMEs to submit an **annual VAT return** instead of quarterly VAT returns (although individual businesses could still opt for the latter);[120] and
- exempting SMEs from having to make **interim VAT payments**. This may pose a problem for the UK's annual accounting scheme (see above), which aims to improve small businesses' cash flow, but only if they accept a requirement to make interim VAT payments throughout the year.[121]

The Government's view

3.43 The Financial Secretary to the Treasury (Mel Stride) submitted an Explanatory Memorandum on the proposal for a revised VAT scheme for small businesses in February 2018.[122] In it, he welcomed the proposals that "reduce the burden placed on SMEs by the administration of VAT and that lessens any VAT threshold-related distortions". The Minister also explains the proposal does not breach the subsidiarity principle, because "consistency of treatment [of small businesses] is more likely to be achieved through action at EU level".

118 See article 290 of the VAT Directive. Businesses could opt for this if they want to be able to deduct input VAT on their supplies.

119 The SME exemption in itself only allows an SME not to charge VAT on their sales (and, as a result, to deduct input VAT). It does not necessarily mean no VAT administrative requirements apply to them. For example, in some Member States SMEs which use the VAT exemption must still register for VAT purposes or issue VAT invoices.

120 At present, article 252 of the VAT Directive makes it optional for Member States to allow annual VAT returns for any business. The Commission proposal would make it compulsory to offer this option to small businesses.

121 The Annual Accounting Scheme in the UK is open to businesses with a turnover below £1.35 million. See also https://www.gov.uk/vat-annual-accounting-scheme/return-and-payment-deadlines.

122 Explanatory Memorandum submitted by HM Treasury (8 February 2018).

3.44 With respect to the extension of the SME exemption from accounting for VAT to all EU businesses, to facilitate cross-border trade, the Minister says:

> "The Government understands that the proposal to allow non-established businesses also to benefit from the UK's SME exemption should reduce the burden of VAT on small businesses. The Government sees the logic in the Commission's suggestion that in a destination based EU VAT system a national SME exemption should apply to non-established businesses as well."

3.45 However, the Minister also identified a number of areas of concern or which require further clarification, namely:

- how the Commission's proposals affecting the VAT threshold for small businesses would interact with the outcome of the Government's own newly-launched consultation on the design of the VAT registration threshold (which the Chancellor first announced at Autumn Budget 2017);[123]
- whether the €100,000 (£88,723) EU-wide turnover threshold, below which businesses could make use of the VAT exemption in another Member State is the "appropriate" limit, and how national tax authorities would monitor and verify the EU-wide turnover figures for businesses established domestically to share with other Member States;
- how the new transitional relief for small businesses which exceed the VAT exemption threshold in a given Member State for the first time would interact with any future Government proposals resulting from its VAT consultation; and
- lastly, the extent to which the proposal would require changes to the UK's Annual Accounting Scheme[124] and invoice storage requirements, and how other Member States would intend to implement the new simplification measures for 'small enterprises'.

3.46 Overall, the Minister concludes that, whilst the Government recognises the merits "of simplifying the VAT obligations of small businesses, more work is needed to review the benefits of such changes". With respect to the implications of Brexit for the UK's VAT regime and its participation in the single VAT area, the Financial Secretary's Explanatory Memorandum is entirely silent.

Previous Committee Reports

None. This is a new proposal.

123 See https://www.gov.uk/government/consultations/vat-registration-threshold-call-for-evidence.

124 See footnote 102 for more information on so-called "cash accounting schemes" to reduce VAT-related administrative burdens on SMEs.'

4 VAT fraud: cooperation between tax administrations

Committee's assessment	Legally and politically important
Committee's decision	Not cleared from scrutiny; further information requested
Document details	Amended proposal for a Council Regulation amending Regulation (EU) No 904/2010 as regards measures to strengthen administrative cooperation in the field of value added tax
Legal base	Article 113 TFEU; consultation procedure; unanimity
Department	Treasury
Document Number	(39299), 14893/17 + ADD 1–2, COM(17) 706

Summary and Committee's conclusions

4.1 Countries across the European Union experience significant evasion of Value Added Tax (VAT), due to fraudsters exploiting a loophole in the EU's common system of VAT for cross-border sales of goods (so-called "missing trader" fraud). The European Commission has estimated that VAT lost to this type of fraudulent activity to amount to €50 billion (£44 billion) annually, including approximately €5 billion (£4.4 billion) of losses to the UK Exchequer.

4.2 Administrative cooperation between EU countries to tackle VAT fraud is currently governed by Regulation 904/2010.[125] It enables Member States to provide assistance to each other on individual taxpayers to correctly assess, control and collect VAT. It provides for exchange of information, some of which is automatic—for example relating to the VAT Information Exchange System (VIES), which contains information on businesses involved in intra-EU sales of goods and services—and some of which is on request, or at the initiative of the sending tax authority.

4.3 As part of a package of measures of reform of Value Added Tax in the EU,[126] the European Commission in November 2017 tabled a proposal amending Regulation 904/2010, to reduce opportunities for VAT fraud. The main objective of the Commission proposal is to amend this legislation to establish a clear legal basis for a new analytical tool, the Transaction Network Analysis (TNA). This application, already operating on a voluntary basis between 25 Member States (but not the UK), provides tax authorities with automated analysis of intra-EU supplies to detect VAT fraud, drawing on information submitted to the EU's existing VAT Information Exchange System (VIES) by the Member States.[127]

125 Council Regulation 904/2010.

126 The other proposals in the package concern the place of taxation for intra-EU supplies of goods and services; the restrictions on EU countries when setting VAT rates; and a special scheme that alleviates the administrative burden of VAT for small businesses. We have considered these in separate chapters in this Report.

127 Each national tax authority in the EU, including HMRC, maintains an electronic database containing the VAT registration data of its traders (.e.g. the VAT identification number, name and address, and supplies made to other EU countries). The EU's VAT Information Exchange System (VIES) was set up to allow for that data to be exchanged, in order to enable VAT administrations to monitor and control the flow of intra-EU trade in goods to detect irregularities.

4.4 In addition, the Commission has proposed various other changes, including improved access for tax authorities to information on car sales and non-EU imports benefiting from a VAT suspension in other Member States (both areas affected by widespread VAT fraud, though with far lower revenue losses than "missing trader" fraud). We have set out the substance of the proposals in more detail in paragraphs 4.31 to 4.40 below.

4.5 The Financial Secretary to the Treasury (Mel Stride) submitted an Explanatory Memorandum on the proposal in February 2018.[128] He expressed the Government's support for the proposed changes, provided they "do not encroach on the competence of Member States to run and administer their national VAT systems". The Memorandum does not make clear why the Government has not so far participated in the TNA tool, and what its view is on that element of the proposed Regulation.

4.6 **The Committee welcomes the momentum behind tackling VAT fraud based on the EU's current system of taxation on cross-border supplies. However, it remains unclear to us why the Government is opposed to joining the TNA project for automated analysis of trade flows to detect VAT fraud, and the Minister's Explanatory Memorandum provides no further clarity in this respect. We therefore ask the Minister to explain:**

- why the UK has not joined the TNA project within Eurofisc;
- whether the amendment to Regulation 904/2010 would provide the legal clarity the Government believes it is necessary to join at a later date; and
- whether the proposed changes would allow the TNA tool to use information on taxable transactions held by HMRC even if the UK does not join the project as such.

4.7 We also consider that this proposal, and the EU legal framework for administrative cooperation between tax authorities more broadly, are important for the UK despite its exit from the EU for two reasons.

4.8 Firstly, during the post-Brexit transitional period, the UK would remain part of the EU's common VAT area as all EU law will continue to apply. As such, the Government would remain bound by the obligation to share information with EU countries under Regulation 904/2010, and have the right to receive information in return. It also means it will have to apply these proposed changes to the Regulation if they become applicable during that period.

4.9 In this respect, we are particularly concerned about the implications of the UK's loss of its veto over tax-related proposals when it exits the EU on 29 March 2019. There is clearly a risk that the substantial changes being proposed to the VAT system by the Commission, of which this proposal on administrative cooperation is only one part, could be adopted against the Government's wishes. Depending on their implementation time, the UK may have to apply these changes to its domestic system of VAT regardless of the fact it was no longer an EU Member State.

4.10 As we have set out in the chapter of this Report on the 'definitive VAT' proposals, we remain to be convinced that the Government's general safeguards against the application of unwanted EU legislation during the transition—namely the fact that the UK will have

128 Explanatory Memorandum submitted by HM Treasury (8 February 2018).

voiced its opinion[129]—on proposals pending before March 2019, or the legal mechanism for resolving these concerns found in Article 123(7) of the draft agreement,[7]**—will be effective in practice. Moreover, any unilateral rejection by the UK of changes to the VAT Directive or its supplementary legislation affecting cross-border trade could be severely disruptive to trade, given the reciprocal and symmetrical nature of the system, including the mechanisms for administrative cooperation under Regulation 904/2010.**

4.11 **Secondly, the Government's desired *post*-transition relationship with the EU on matters of value added tax remains entirely unclear. The closer the level of economic integration, the greater the presumed need for a continued mechanism of formalised cooperation to combat VAT fraud.**

4.12 **This is particularly true in the context of the Government's ambition of an Irish border free of any physical customs infrastructure. Outside the common VAT area, value added tax is collected on import. In the absence of systematic monitoring of goods coming into the UK, the Government would presumably have to remain part of, or functionally replicate, the VAT cooperation mechanisms laid down in Regulation 904/2010 to ensure it was aware of movements of goods into the UK on which VAT needed to be levied. That, in turn, would require the UK to effectively remain in the single EU VAT area to avoid instances of double- or non-taxation that could arise if the Government changes domestic rules about when VAT liabilities arise and who is responsible for VAT returns.**

4.13 **So far, we have not received any detail from the Government about the hoped-for substance of any UK-EU cooperation agreement on VAT. In December 2017, we raised the example of a recent EU-Norway Agreement, which effectively includes Norway in most of the EU's cooperation mechanisms in the field of VAT, as a possible template. In response, the Minister has only felt able to say that the Agreement is "useful". While we may take this as a sign that it could form the basis for a future UK-EU treaty, we note that Norway remains outside the common VAT area; and that consequently Norwegian goods sold into the EU incur VAT at the moment of importation. The Agreement would therefore need substantial modification before it would meet the Government's requirements in avoiding the need for customs infrastructure.**

4.14 **We will continue to press the Government for clarity on these matters, given that it purports to want to start substantive trade negotiations with the EU in March without having publicly stated what the future agreement should look like, or how it proposes to resolve the potential for VAT evasion at the Northern Irish border if no frontier controls are in place. In the interim, we retain the proposal on administrative cooperation under scrutiny.**

129 On 9 October 2017, the Prime Minister told the House: "Given the way things operate, it is highly unlikely that anything will be brought forward during that period that has not already started discussions through the European Union to which we are being party of until we leave and on which we would have been able to say whether they would be a rule that we would sign up to or a rule that we would not wish to sign up to. Any new rules put on the table during the implementation period, given the way these things operate, are highly unlikely to be implemented during the implementation period."

Full details of the documents

Amended proposal for a Council Regulation amending Regulation (EU) No 904/2010 as regards measures to strengthen administrative cooperation in the field of value added tax: (39299), 14893/17 + ADD1–2, COM(17) 706.

Background

4.15 In October 2017 the European Commission published a legislative proposal for a "definitive system" for applying VAT to cross-border sales within the EU, which aims to tackle the underlying causes of cross-border VAT fraud which costs EU governments €50 billion in lost tax revenues each year. We set out the details of this proposal in more detail in December 2017[130] and provide an update on the Government's position in a separate chapter in this Report.

4.16 While negotiations on that file are on-going within the Council, the Commission has also tabled a number of supplementary proposals, including a new Regulation to reinforce administrative cooperation between the EU's tax authorities, with the aim of addressing the most common forms of VAT fraud under the current system.[131] This new legislation also aims to prepare the ground for the greater degree of trust between national tax authorities as foreseen by the proposed new VAT system, under which Member States would collect VAT revenue for each other in certain circumstances.

4.17 Below, we have set out in more detail the background to the proposal; the types of fraud it is seeking to address; and the substance of the changes proposed by the Commission.

The EU's common system of VAT

4.18 The EU has established a common system of value added tax (VAT) system which is currently governed primarily by Directive 2006/112/EC (the VAT Directive).[132] For cross-border trade within the EU, the Directive stipulates that VAT must be paid in the Member State where a goods or service is supplied, which ordinarily means in the country where the customer is based or takes possession of the goods.[133]

4.19 Prior to the abolition of customs controls as part of the establishment of an internal market in 1993, a trader who imported a product from another EU country would have to pay VAT to their national customs authorities before the good could be released. When such controls were removed, the Member States introduced—on a supposed transitional basis—a new system for cross-border business-to-business sales. In practice, the current, complex arrangement means a cross-border sale is split into two transactions: a zero-rated supply in the Member State of the supplier of the goods (meaning the exporter obtains a rebate of all their input VAT, and the customer is not charged any VAT), and an "intra-

130 See for more information our Report of 6 December 2017.

131 The other supplementary proposals would affect restrictions on VAT rates and the VAT obligations of small businesses. We have discussed these in separate chapters in this Report.

132 European Commission, "Cross-border VAT" (accessed 5 January 2018).

133 The Directive however contains various exemptions to this general principle, for example, where services are supplied to a consumer (in which case VAT is normally paid in the Member State of the supplier irrespective of the location of the customer).

Community acquisition" in the Member State of destination (meaning that, as a second step, the importer effectively charges themselves VAT and pays it to their national tax authority).

Cross-border VAT fraud

4.20 While this system allowed for the abolition of intra-EU customs controls, it has also provided opportunities for three main types of VAT fraud, which are centred on the ability of traders to make a purchase with a zero-rate of VAT from another EU country:

- **Missing trader intra-Community carrousel (MTIC) fraud**, where importers make a zero-rated purchase, sell on the goods domestically (including VAT) but do not remit the tax collected to their national Exchequer and pocket the difference. This type of VAT fraud is estimated to cost EU governments up to €50 billion (£44 billion)[134] annually;

- Fraud perpetrated by **abuse of customs procedures 42 and 63**, which allow goods imported from outside the EU to be released by customs without VAT having been paid. These procedures are meant to be used for import of goods which are for immediate delivery to the importer in another EU Member State. In practice, these customs procedures are often abused to circumvent paying VAT, after which the goods disappear onto the black market.[135] The European Commission are currently in discussions about the prevalence of this type of VAT fraud at British ports;[136] and

- **Second-hand car fraud**, which abuses the different VAT treatment of cross-border supplies of new and used vehicles (for the former, VAT over the total transaction must be paid; for the latter, VAT is only paid on the profit margin). This type of fraud allows traders to acquire luxury cars at a lower price, and sell them on below market prices. Although there is no firm data on the size of this type of fraud, Member States reported €1.5 billion (£1.3 billion) of transactions relating to suspected fraud involving cars in 2015 (down from €5 billion (£4.4 billion) in 2013.[137]

Administrative cooperation to tackle VAT fraud

4.21 An EU-level legislative framework for administrative cooperation on value added tax was created in 1992,[138] in recognition of the potential difficulties posed by the elimination of customs controls on intra-EU movement of goods.[139] The Regulation on Administrative Cooperation was comprehensively revised in 2003[140] and again in 2010.[141]

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134 €1 = £0.88415 or £1 = €1.13103 as at 28 February.

135 In 2015, there were 8.5 million import transactions across the EU with a VAT exemption under CPs 42 and 63, with a total value of €74 billion (£66 billion). The cost of this type of VAT fraud has not been quantified.

136 See our Reports of 29 November 2017 and 24 January 2018 for more information on EU investigations into VAT and customs fraud in the UK. On 8 March, the European Commission formally called on the UK to compensate the EU for losses to the EU budget from the UK's failure to collect customs duties and VAT on imports.

137 Commission Impact Assessment, p. 20.

138 Regulation 218/92 on administrative cooperation in the field of indirect taxation (VAT).

139 See paragraph 0.18 for more information on the creation of the current VAT system.

140 Council Regulation (EC) 1798/2003.

141 Council Regulation (EU) 904/2010.

4.22 Under the terms of the Regulation as it stands, Member States provide assistance to each other to correctly assess, control and collect VAT. It provides for exchange of information, some of which is automatic—for example relating to the VAT Information Exchange System (VIES), which contains information on businesses involved in intra-EU sales—and some of which is on request or at the initiative of the sending tax authority.

4.23 Exchange of information on request on VAT matters often requires a so-called "administrative enquiry",[142] where the tax authority of one EU country asks its counterpart in another EU country to obtain information that may help assessing the VAT liability of a particular taxpayer. The Member State receiving the query can make inquiries with any relevant businesses, acting for the other Member State as if it were acting on its own behalf. Officials from the other EU country may also request to be present during any on-site visits.

4.24 Regulation 904/2010 also created "Eurofisc", a mechanism to improve cooperation in combating organised VAT fraud, and especially missing trader fraud. It is a network of tax officials, allowing tax authorities to exchange the results of their analytical work in identifying VAT fraud on an *ad hoc* basis. It has several "working fields", including for the three main types of VAT fraud affecting intra-EU sales (see paragraph 4.20 above). While all EU Member States are represented in Eurofisc, each individual country decides how to contribute to a Working Field on a voluntary basis.

4.25 These efforts notwithstanding, the European Commission[143] and the European Court of Auditors[144] are of the view that the Member States' instruments for administrative cooperation in the EU must be "put to greater and better use". In particular, the Commission has concluded Regulation 904/2010 falls short of its full potential because some relevant data (for example on car registrations used in second-hand car fraud) is not automatically swapped; EU-level law enforcement bodies do not receive information available to national authorities; and the *ad hoc* exchange of information on fraud patterns and risks via Eurofisc is labour-intensive and slow.

Moving to a "definitive system" of Value Added Tax

4.26 Given the scale of VAT fraud made possible by the EU's current common system of VAT for cross-border sales despite the existing mechanisms for cooperation, and in recognition of the system's complexities, the European Commission published a VAT Action Plan in April 2016. This contained short and medium-term measures to modernise the EU VAT system and make it "simpler, more fraud-proof and business-friendly".[145]

4.27 The key measure outlined in the Action Plan was an amendment to the VAT Directive for a "definitive system" of value added tax.[146] First and foremost, this envisaged

142 The Regulation defines "administrative enquiries" as "all the controls, checks and other action taken by Member States in the performance of their duties with a view to ensuring proper application of VAT legislation".

143 European Commission report on the application of Council Regulation (EU) no 904/2010 (COM(2014) 71, 12 February 2014). Considered by the previous Committee on 19 March 2014.

144 European Court of Auditors report 2015/24, "Tackling intra-Community VAT fraud: more action needed" (March 2015).

145 European Commission document COM(2016) 148. Cleared from scrutiny by debate in European Committee B on 21 February 2017.

146 Other measures announced in the Action Plan include the B2C e-commerce VAT package (see our Report of 24 January 2018), adopted by the Council in December 2017 and reform of the EU's system of VAT rates (which we consider elsewhere in this Report).

amendment to the VAT Directive would restrict (but not eliminate) the opportunities for zero-rated cross-border purchases by ordinarily making the supplier—not the customer, as at present—liable for ensuring VAT was paid to the tax authority of the Member State of consumption.[147] In addition—to reduce the resulting administrative burden on suppliers—the proposal would also allow traders to pay VAT due in another EU country to their national tax authority, via an accounting mechanism known as the "One Stop Shop" (OSS).[148] Revenue collected via the OSS which would then be remitted to the Member State of the customer.[149]

4.28 In October 2017 the Commission tabled a proposal to legislate for the principle of such a change, with further detailed legislative measures to follow in 2018. The Committee considered these changes to the VAT Directive separately in December 2017.[150] In light of information we have received from the Treasury since, we consider the Government's position on the "definitive system" again in a separate chapter of this Report. Negotiations on the overarching proposals to change VAT on cross-border sales within the EU remain under discussion in the Council, with consideration by EU Finance Ministers currently scheduled for the May 2018 ECOFIN Council. They are not expected to be adopted until 2019 at the earliest, with entry into force in 2022 or later.

4.29 Given this long lead-in time for the reforms, opportunities for missing trader fraud and other types of VAT evasion are likely to persist for some time. As a result, the Commission took the view that shorter-term measures would also be necessary to scale back the levels of cross-border VAT fraud. In November 2017 it therefore also tabled draft legislation to improve the exchange and analysis of information by tax administrations (governed by Regulation 904/2010). The proposal also aims to further improve trust between the EU's national tax authorities, in preparation for the foreseen expanded use of the One Stop Shop for cross-border B2B supplies. That system will require a substantial degree of confidence between the Member States because they would effectively have to trust another country to collect a large source of tax revenue on its behalf and remit it correctly.[151]

4.30 The Commission proposal technically modifies a pending legislative proposal to amend Regulation 904/2010, on the introduction of the Certified Taxable Person as part of the "definitive VAT system".[152]

147 The Commission proposal also seeks to introduce the legal concept of a "Certified Taxable Person" (CTP). In the context of the transition to the "definitive system" of VAT, where a buyer has CTP status, they would remain liable to account for VAT on cross-border purchases, in derogation from the proposed principle that the supplier should have that responsibility.

148 As the details of the changes to the VAT system are yet to be decided, it is unclear whether UK-based businesses will be able to make use of the OSS for sales into the EU after Brexit.

149 At present, an embryonic version of the OSS (known as the "Mini One Stop Shop") is used only by traders who supply electronic services to consumers based in another EU country. See our Report on the B2C e-commerce VAT package of 24 January 2018 for more information on the Mini One Stop Shop. The Mini One Stop Shop can also be used by non-EU traders, who have to register for VAT in an EU Member State to make use of it.

150 See Report of 6 December 2017.

151 In 2015, Value Added Tax raised slightly more than €1 trillion (£880 billion) across the EU, representing 17.6 per cent of total national tax revenues in the Union (see Eurostat).

152 The new concept of a 'Certified Taxable Person' is in essence a business certified as a reliable taxpayer by their national tax authority. The earlier proposed amendment to Regulation 904/2010 would allow such certification, once granted, to be entered into the VAT Information Exchange System so all Member States can see which businesses hold CTP status.

The Commission proposal

4.31 The Commission has now proposed to amend Regulation 904/2010 to address these perceived shortcomings. They would enter into force in three different stages, depending on the level of preparatory work required. We have summarised the substance of the Commission proposals below.

Eurofisc

4.32 Within Eurofisc, the European Commission and most Member States are already developing a voluntary tool for information exchange and joint processing of VAT data for called Transaction Network Analysis (TNA). Although the TNA does not expand the types of information exchanged via Eurofisc, it would reduce the amount of manual labour involved in such exchanges by introducing automatic data collection, for example through VIES. The tool also seeks to improve ways of detecting VAT fraud early by mining this data in a systematic way.

4.33 Twenty-five Member States are currently participating in the Eurofisc Working Field related to the development of the TNA tool, with Germany and Slovenia having observer status. The UK is the only Member State not involved in this Working Field, with the Government having taken the view within Eurofisc that it needs a "clearer legal framework in order to participate".[153] The Commission is therefore proposing to amend Regulation 904/2010 to provide a clear legal basis for joint processing and analysis of data within Eurofisc through the TNA. Although participation by Member States in such activities would remain voluntary, where a Member State joins the TNA Working Field, its authorities should grant Eurofisc officials access to their VIES data on intra-Union transactions.

4.34 The Commission has also asked non-participating Member States (i.e. Germany, Slovenia and the UK) to grant such access, to allow the software to "identify all potential fraud networks, including those involving traders established in non-participating Member States". The amendments would also allow Eurofisc officials to coordinate administrative enquiries initiated by Member States in response to the risk analyses produced by this new tool.[154] In addition, the network would be allowed to forward information on VAT fraud trends, risks and serious cases to Europol and the European Anti-Fraud Office (OLAF). Its officials would also be permitted to disclose information on such cases to the European Public Prosecutors' Office (EPPO).[155]

4.35 The Minister's Explanatory Memorandum does not refer to the UK's current status as a non-participant and non-observer in the TNA working party, or explain the Government's reasons for having taken this position.

Exchange of information on imports and car registrations

4.36 In response to the levels of fraud committed using customs procedures 42 and 63 and the dual VAT regime for cars (see paragraph 4.20 above), the Commission proposes to

153 See Commission document SWD(2017) 428, p. 38.

154 See paragraph 4.23 for more information on administrative enquiries.

155 The EPPO will have an interest as it will investigate and prosecute crimes affecting the EU's financial interests. A small proportion of each EU country's VAT receipts are passed to the European Commission to finance the EU budget, meaning that VAT fraud affects the EU's financial interests by reducing this revenue stream.

allow for automated access to each Member State's databases on vehicle registrations and on imports from outside the EU where VAT is suspended while the goods are transported to the Member State of destination. These new access requirements would become applicable in January 2020.

4.37 With respect to vehicle registrations, the Commission proposes to grant national tax authorities access to the EUCARIS platform, where automated information exchange on vehicle registrations between EU Member States already takes place.[156]

4.38 As regards imported goods for onward supply under customs procedures 42 and 63, the proposal seeks to ensure that the customs authorities of the Member State of import would share information—on the consignment, the VAT numbers of the importer and the intended recipient—with the tax authorities of the declared Member State of destination. This would allow the tax authorities in both countries to cross-check this information with the information reported by the importer in their eventual recapitulative statement and VAT return, and by the recipient in his VAT return. This would also allow the Member State of destination to inform the customs authorities of in the Member State of import if the VAT number for the recipient business has been 'hijacked'.[157]

4.39 In addition, the amended Regulation would allow all EU customs authorities to access VIES to ensure that the VAT identification numbers of the importer and the recipient of the goods are valid before authorising a VAT suspension under customs procedure 42 or 63. The Commission notes that such access is already available to the customs authorities of 23 Member States, and would therefore only have the effect of forcing the remaining five EU countries to follow suit.[158]

Other changes

4.40 The proposal to amend Regulation 904/2010 would make a number of supplementary changes, namely:

- provide a basis for **joint audits** by multiple national tax authorities, where officials form a single audit team and participate jointly in an administrative enquiry (where one Member State makes inquiries into the VAT matters of a business located on its territory on behalf of another Member State);
- remove certain restrictions on allowing a Member State to **check transactions in the VAT Information Exchange System** (VIES) when the transaction does not directly involve the Member State doing the checking;
- require the European Commission to **publish information on VAT rates and simplified VAT schemes for small businesses**[159] in each Member State from July 2021. At present, it only publishes information related to each country's national VAT invoicing rules;[160] and

156 EUCARIS is the European car and driving licence information system. All EU countries participate in it under Council Decisions 2008/615/JHA and 2008/616/JHA.

157 "Hijacking" of VAT numbers occurs where a valid VAT number is used but the identified business is not the real customer.

158 See Commission document SWD(2017) 428, p. 44.

159 Both the EU-level rules on VAT rates and special VAT exemptions from small businesses are subject to separate amending proposals, which we have considered elsewhere in this Report.

160 See http://ec.europa.eu/taxation_customs/tic/public/index.html.

- with respect to cooperation between Member States on using **refunds for VAT incurred in another EU country** to settle VAT liabilities in a business' home country,[161] make it easier for such refunds to be transferred directly to the tax authorities of the latter to make good on outstanding VAT debts (with the consent of the business in question).[162]

The EU-Norway Agreement on cooperation in VAT fraud

4.41 The EU is not only seeking to strengthen cooperation on tackling VAT fraud between its Member States. In its 2012 Action Plan on tax fraud, the Commission also outlined the need for new EU-level agreements with non-EU countries used by organised crime groups to perpetrate VAT fraud, in particular Norway, Russia, Canada, Turkey and China.

4.42 The talks with the latter four countries are apparently on hold. However, in spring 2017 the European Commission concluded two years of negotiations with Norway—which is part of the Single Market but not bound by EU VAT law—and submitted it to the Member States for formal signature and conclusion (ratification) in October. The new treaty in effect includes Norway in the systems created by Council Regulation 904/2010 and Council Directive 2010/24/EU to Norway, including Eurofisc. However, Oslo will not be given access to the Member States' national VAT databases, nor the EU's VAT Information Exchange System (VIES) on intra-EU supplies.

4.43 The Committee cleared the Agreement from scrutiny in December 2017, but asked for further information from the Minister about its value as a template or basis for a future UK-EU cooperation agreement on VAT fraud after Brexit.[163] The Financial Secretary replied on 8 February,[164] stating that:

- Information exchange and cooperation "continue to be… useful tools" to counter VAT fraud, and the Eurofisc system has provided benefits for the UK, serving "mainly to confirm HMRC's existing profiling and risking rather than identifying unknown fraudsters, broadly showing our domestic systems to be robust";
- After Brexit, "continued access to the exchange of good practice and discussion of wider development and trends would be useful", but "other fora"—like the European Organisation of Tax Administrations—are available for that purpose; and

161 Where an EU-based company incurs a business expense in another EU country and therefore pay VAT at the rate of the supplier's country, they can get the VAT refunded in the same was as VAT on domestic business expenses or intra-EU acquisitions (input VAT) can be offset against output VAT on a domestic VAT return. This is because VAT is a neutral tax throughout the supply chain, in the sense that the total VAT charge should only be paid by the final consumer. See Directive 2008/9/EC for more information.

162 At present, the Member State where the business is established can ask the Member State where the business expenses were incurred to "recover" the VAT refund, to pay off VAT liabilities in the country of establishment. Alternatively, where the VAT liabilities are disputed, they can be seized as a "precautionary measure". However, the procedures for this is cumbersome and the business involved can only legally challenge seizure of the VAT refund before the courts of the Member State of refund, not of their home country.

163 See the Committee's Report of 6 December 2017.

164 Letter from Mel Stride to Sir William Cash (8 February 2018).

- Although not committing to seeking "similar arrangements" to Norway's for the UK after Brexit, the Minister notes that "it will […] be useful for there to be an agreement in place" even if the EU-Norway treaty "is not seen as creating a precedent".

Previous Committee Reports

None with respect to the Eurofisc proposal. For the Committee's previous consideration of the EU-Norway VAT Agreement, see: (39175), 13774/17 + ADD 1, COM(17) 624: Fourth Report HC 301–iv (2017–19), chapter 15 (6 December 2017).

Formal Minutes

Wednesday 28 March 2018

Members present:

Sir William Cash, in the Chair

Geraint Davies	David Jones
Steve Double	Stephen Kinnock
Marcus Fysh	Andrew Lewer
Kate Green	Michael Tomlinson
Kelvin Hopkins	David Warburton
Darren Jones	Dr Philippa Whitford

3. Scrutiny report

Draft Report, *Value Added Tax: EU proposals for reform and the implications of Brexit*, proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1.1 to 4.43 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Twenty-third Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

[Adjourned till Wednesday 18 April at 1.45pm.

Standing Order and membership

The European Scrutiny Committee is appointed under Standing Order No. 143 to examine European Union documents and—

a) to report its opinion on the legal and political importance of each such document and, where it considers appropriate, to report also on the reasons for its opinion and on any matters of principle, policy or law which may be affected;

b) to make recommendations for the further consideration of any such document pursuant to Standing Order No. 119 (European Committees); and

c) to consider any issue arising upon any such document or group of documents, or related matters.

The expression "European Union document" covers—

i) any proposal under the Community Treaties for legislation by the Council or the Council acting jointly with the European Parliament;

ii) any document which is published for submission to the European Council, the Council or the European Central Bank;

iii) any proposal for a common strategy, a joint action or a common position under Title V of the Treaty on European Union which is prepared for submission to the Council or to the European Council;

iv) any proposal for a common position, framework decision, decision or a convention under Title VI of the Treaty on European Union which is prepared for submission to the Council;

v) any document (not falling within (ii), (iii) or (iv) above) which is published by one Union institution for or with a view to submission to another Union institution and which does not relate exclusively to consideration of any proposal for legislation;

vi) any other document relating to European Union matters deposited in the House by a Minister of the Crown.

The Committee's powers are set out in Standing Order No. 143.

The scrutiny reserve resolution, passed by the House, provides that Ministers should not give agreement to EU proposals which have not been cleared by the European Scrutiny Committee, or on which, when they have been recommended by the Committee for debate, the House has not yet agreed a resolution. The scrutiny reserve resolution is printed with the House's Standing Orders, which are available at www.parliament.uk.

Current membership

Sir William Cash MP (*Conservative, Stone*) (Chair)

Douglas Chapman MP (*Scottish National Party, Dunfermline and West Fife*)

Geraint Davies MP (*Labour (Co-op), Swansea West*)

Steve Double MP (*Conservative, St Austell and Newquay*)

Richard Drax MP (*Conservative, South Dorset*)

Mr Marcus Fysh MP (*Conservative, Yeovil*)

Kate Green MP (*Labour, Stretford and Urmston*)

Kate Hoey MP (*Labour, Vauxhall*)

Kelvin Hopkins MP (*Independent, Luton North*)

Darren Jones MP (*Labour, Bristol North West*)

Mr David Jones MP (*Conservative, Clwyd West*)

Stephen Kinnock MP (*Labour, Aberavon*)

Andrew Lewer MP (*Conservative, Northampton South*)

Michael Tomlinson MP (*Conservative, Mid Dorset and North Poole*)

David Warburton MP (*Conservative, Somerton and Frome*)

Dr Philippa Whitford MP (*Scottish National Party, Central Ayrshire*)