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EU Tax on Digitally Delivered E-Commerce

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Summary

On July 1, 2003, the European Union (EU) began requiring U.S. and other non-EU firms to pay value added tax (VAT) on the sale of goods and services digitally delivered to individual customers in the EU. The tax rules apply to the supply over electronic networks (digital delivery) of software and computer services generally, plus a wide array of information services. U.S. and other non-EU firms are required to register in one EU country but pay the VAT at the rate applicable in each customer's country. In contrast, EU firms pay tax at the single rate of the country in which they are located.

EU taxation of digital transactions raises several policy questions for the United States. These include the taxation of digital commerce, unequal taxation of EU versus non-EU firms, high tax compliance costs, EU competition with the Organization for Economic Cooperation and Development's (OECD's) multilateral discussions of the taxation of e-commerce, and the possibility of a complaint to the World Trade Organization (WTO). The issue of requiring a foreign firm to collect tax on sales at multiple rates depending on the customer's country of residence is similar to the domestic issue, raised in connection with the Internet tax moratorium, of possibly requiring U.S. sellers to collect tax on interstate sales based on the tax in the customer's state of residence. This report will be updated as events warrant.

Overview and Background

On July 1, 2003, the European Union (EU) began requiring U.S. and other firms located outside the EU to pay value added tax (VAT) on the sale of goods and services digitally delivered to individual consumers in EU countries. The VAT on E-Commerce Directive (2002/38/EC, May 7, 2002) amended earlier EU tax legislation, changing the rules for VAT collection on digitally delivered products. EU firms are no longer required to pay tax on exports from the EU. Non-EU firms are now required to pay a tax on their sales to individual consumers within the EU (imports into the EU). EU firms pay the single VAT rate for the country where they are located. (As described below, these changes conform the tax treatment of digital commerce to that of other goods and services.) If a non-EU firm establishes a subsidiary in an EU country, it can follow the tax rules for EU companies and pay a single rate. Otherwise, non-EU firms are required to register in one EU country and pay the VAT on each sale at the tax rate in the customer's home EU country. Thus, non-EU companies must collect potentially up to 25 separate VAT rates, corresponding to the 25 member countries of the EU.

A value added tax is a broad-based consumption tax on goods and services, levied at each stage of production. Under the EU's credit-invoice VAT, a business receives a credit for the VAT paid on its purchases of inputs against the tax due on its sales of output. The VAT is typically rebated on exports and imposed on imports. In contrast, the retail sales tax used by U.S. states is levied primarily on goods, at the point of final sale. The United States is the only major economy that does not levy some form of VAT.

Prior to July 1, 2003, EU e-commerce transactions, including goods and services delivered in both tangible and digital form, were taxed under the EC (European Community) Sixth VAT Directive (Directive 77/388/EEC). The VAT was collected from EU companies on all sales, including exports to customers outside of Europe. As noted above, this contrasted to the treatment of other exports, for which the VAT was rebated. For EU companies, no distinction was made between physically and digitally delivered goods. In contrast, non-EU companies were taxed on imports of tangible goods and services but not taxed on imports electronically delivered into Europe.

The EU's taxation of digital commerce by non-EU firms moves counter to a stated U.S. goal of keeping Internet transactions free from tax, both within the United States and worldwide. However, it moves in the direction favored by many U.S. states of broadening the state sales tax base to include digital goods and services and of supporting interjurisdictional tax collection.

Conditions of the Directive

The VAT on E-Commerce Directive makes two substantive changes to the taxation of digitally delivered e-commerce transactions.

- Non-EU firms are now required to pay tax on e-commerce transactions digitally delivered into Europe.

- EU companies are no longer required to pay tax on digitally delivered sales occurring outside of Europe.

The tax rules for non-EU companies apply to the supply over electronic networks (i.e., digital delivery) of software and computer services generally, plus information and cultural, artistic, sporting, scientific, educational, entertainment or similar services as well as broadcasting services. Examples include Web-hosting, sales of downloadable software and upgrades, the sale of electronic books, streaming music, digital movies, computer games, and distance-learning services.

A key distinction is that the new VAT rules apply to goods and services that are digitally delivered to individual consumers (business-to-consumer or B2C sales). This directive does not apply to business-to-business (B2B) sales. B2B sales, which reportedly comprise 90% of the $422 billion e-commerce market,[1] are taxed under other previous EU legislation.

Under a special provision for non-EU businesses, a non-EU firm need register in only one EU country (rather than all 25). However, a non-EU firm must pay VAT based on the tax rate applying in the country of each EU customer. The firm is to remit all tax to the country in which it is registered. The member state of registration is then responsible for distributing the appropriate amount of revenue due to each of the other member countries of the EU, based on the firm's sales to customers in each country.

European Reasons for the New Directive

To many European observers, the impetus for the directive was that the prior tax system placed EU firms at a competitive disadvantage to non-EU firms. The prior system levied the VAT on European firms' digital commerce transactions both inside and outside the EU, but did not tax non-EU suppliers on sales within the EU. In a May 7, 2002, press release, Frits Bolkestein, European Commissioner for Taxation, remarked "They [the new tax rules] will remove the serious competitive handicap which EU firms currently face in comparison with non-EU suppliers of digital services both when exporting to world markets and when selling to European consumers." Some observers, on both sides of the Atlantic, maintain that the Directive was proposed and passed on political rather than economic justifications. By making the compliance costs higher for non-EU firms, many contend that the new regulations are a non-tariff barrier that will prevent some firms from selling their digitally delivered goods within Europe.

The new directive accords similar VAT treatment to digital commerce that the EU applies to exports and imports of tangible products: the VAT on most goods and services is rebated on exports and imposed on imports. Rather than placing foreign, non-European firms at a disadvantage, these border tax adjustments are widely viewed as ensuring that non-European products face the same VAT tax burden as do European products. EU officials have argued that the new VAT directive is necessary to maintain EU competitiveness with non-EU firms that were previously paying no VAT at all on their European sales. It is seen as leveling the playing field between EU and non-EU firms.

An initial version of the directive would have permitted non-EU companies to register in one EU country and pay tax at that country's rate. The concern, especially for high VAT nations such as Sweden, was that most firms would register in the lowest-tax jurisdictions of Madeira or Luxembourg. The products of these non-EU firms would then bear the lowest tax rates when competing against the products of firms from other EU countries. As an alternative, it was decided in the final directive that non-EU firms should be taxed based on the destination principle, at the tax rate of the EU country of consumption. Imports from outside the EU are thus taxed at the same rate as products and

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[1] Paul Hofheinz, "EU Approves New Rules on Taxation of E-Commerce," *The Wall Street Journal*, May 7, 2002.

services produced in the customer's home country. This tax rate may be higher or lower than the rate paid on products from other EU countries.

Issues of Concern to the United States

The EU VAT on E-Commerce Directive has raised concerns from the Bush Administration, Congress, and U.S. companies. These include the taxation of digital commerce, possible discriminatory taxation of non-EU firms compared with EU firms through unequal tax rates and higher compliance costs, and whether the new EU directive undercuts multilateral discussions of e-commerce taxation under the auspices of the Organization for Economic Cooperation and Development (OECD).

Taxation of Digital Commerce. In the United States as well as the EU, opponents of any tax on e-commerce have used the infant industry argument to ask for exemption from sales tax or the VAT to allow e-commerce to grow unhampered by taxes on transactions. Imposing the VAT on sales into the EU of digitally supplied goods and services will raise the costs faced by U.S. exporters, leading them to try to raise the prices they charge EU customers. Higher prices are likely to reduce the amount of exports to the EU by U.S. companies. Firms in highly competitive industries, which are not able to pass along the tax (and compliance costs) in higher prices, may curtail their exports to EU customers. Note, however, that under prior EU law U.S. exporters received a VAT advantage, and U.S. digital exports may have been artificially high.

Unequal Tax Rates. While European firms have to pay only one tax rate, in 2003, non-EU firms paid up to 15 separate tax rates on digitally delivered commerce into the EU, depending on their customers' country of residence. In 2004 the number of rates increased to 25 when the EU expanded to include 10 additional countries from Eastern and Southern Europe. As of 2005, VAT rates range from 13% on the Portuguese island of Madeira to 25% in Sweden. The lowest rate on continental Europe is 15% in Luxembourg. A Luxembourg company selling a digital product in Sweden, for example, would be subject to Luxembourg's 15% VAT rate, while an American firm selling the same product in Sweden would be subject to Sweden's 25% rate. U.S. Treasury officials have commented negatively on the VAT rules. Tara Bradshaw, a Treasury Department spokesperson, reportedly said that the new rules would have a disproportionate effect on non-EU businesses.[2]

EU firms, while subject to other restrictions, can move their operations to take advantage of lower tax rates. For example, Freeserve, a United Kingdom Internet provider, moved its servers to Madeira in 2002 to take advantage of its 13% tax rate. Non-EU firms can do the same by establishing a EU subsidiary. AOL, which has a European subsidiary, moved its European headquarters to Luxembourg so it could apply Luxembourg's 15% rate for all of its European customers.[3] However, most non-EU companies are likely to be subject to the tax rate in the customer's home country, while most EU companies are likely to be subject to the tax rate of their home country.

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[2] Matthew Newman, The Economy: AOL, eBay, Amazon Add Levies in EU as Taxes Hit Web Sales, *The Wall Street Journal*, July 2, 2003, A2.

[3] Ibid.

Higher Compliance Costs. The compliance costs associated with collecting such a large number of different VAT rates could be relatively high for individual firms. Determining the location of customers can be very difficult, if not near impossible, for digitally delivered products. The delivery of products downloaded from the Internet is fundamentally different from the delivery of tangible items that are mailed to a physical address. Someone using the Internet might be able to hide or conceal their actual location. Considering the small size of the business-to-consumer (B2C) market (the new rules cover approximately 10% of the European e-commerce market), some analysts argue that the cost of implementing the new tax structure will likely exceed the tax revenue gained. The combination of higher tax compliance costs plus the new tax liability might price some non-EU suppliers out of the EU market.

EU vs. OECD Approach to E-Commerce Taxation. In Europe, there has been a growing movement to implement taxation of some sort on electronic commerce. European tax systems are viewed by some as the model for countries worldwide. The U.S. Chamber of Commerce argues and the European Commission acknowledges that the EU's new taxation policy could set a global precedent.[4]

The United States and the EU are currently negotiating a global accord regarding the taxation of e-commerce under the auspices of the Organization for Economic Cooperation and Development (OECD) in Paris.[5] The OECD's Taxation Framework Conditions, agreed to in Ottawa, Canada, in 1998, provided initial principles to guide countries in their policy towards e-commerce taxation. The OECD's Model Income Tax Treaty is used to set guidelines and resolve tax disputes among member OECD countries. The Treaty allows countries to tax business activities that have a so-called "permanent establishment" in a country. Much of the future debate on a global tax accord will center on how "permanent establishment" is defined for use in e-commerce. OECD member countries have agreed that a Web-site alone does not constitute a permanent establishment. However, the physical location of servers or other computer equipment may constitute permanent establishment.[6] OECD member countries are continuing their work to implement the Ottawa Taxation Framework Conditions.[7]

Some U.S. observers assert that the EU directive undercuts these multilateral OECD initiatives. In a February 8, 2002 speech, U.S. Deputy Treasury Secretary Kenneth W. Dam remarked on the yet-to-be-enacted EU legislation that "The proposal may potentially be inconsistent with the international trade obligations in the World Trade Organization" and that "...unilateral proposals such as the EU's may encourage others to take unilateral measures, rather than waiting for the global consensus that can be developed through a deliberative and inclusive process, such as the OECD's."[8]

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[4] Brian Krebs, EU Stirs Up Internet Sales Tax Debate, *The Washington Post*, June 9, 2003.

[5] See [http://www.oecd.org/topic/0,2686,en_2649_37427_1_1_1_1_37427,00.html].

[6] OECD Countries Agree on the Interpretation of a Key Condition for Taxing Profits from Foreign E-Commerce Business, OECD Press Release, Sept. 1, 2001.

[7] For more information on the OECD's progress, see the OECD website [http://www.oecd.org].

[8] Statement by Deputy Treasury Secretary Kenneth W. Dam on European Union E-Commerce Tax Proposal, Feb. 8, 2002.

Possible Complaint to the WTO. In 2003, there was some talk of the United States filing a complaint with the World Trade Organization (WTO) regarding the requirement that non-EU companies collect multiple VAT rates and its use as a discriminatory tool. Although no complaint was ever formally brought, Karen Myers, Chairman of the United States Council for International Business's Subcommittee on e-Commerce, stated in testimony before Congress that the disparity in VAT rates for EU and non-EU firms might not be consistent with WTO rules.[9] This point was acknowledged by the European Commission, which initially supported the earlier EU proposal allowing non-EU firms to register in one country and pay only its rate. For two years prior to the adoption of the Directive, the European Commission (EC) argued that a system such as the one now in place is discriminatory and could lead to a complaint at the WTO. The EC position was overruled by certain high-VAT members of the EU.[10]

Similar Controversy within the U.S. over Taxation of Interstate Sales and Digital Commerce

Concern about the compliance costs for U.S. firms to pay VAT taxes on digital imports into the EU based on the tax rate of each customer's home country parallels the debate about whether states should be able to require out-of-state remote sellers to collect sales and uses taxes on interstate sales, based on the tax in the customer's home jurisdiction. Through the Streamlined Sales Tax Project (SSTP), states are trying to simplify and standardize their sales tax systems in order to reduce compliance costs. In the 106th and 107th Congresses, the interstate sales tax issue was raised in connection with the Internet Tax Freedom Act (ITFA). In the 108th Congress, it was treated separately. The Subcommittee on Commercial and Administrative Law of the House Judiciary Committee held hearings on the states' streamlined sales and use tax (SSUTA). Companion bills H.R. 3184 and S. 1736 would have granted states that comply with the SSUTA the authority to require remote sellers to collect state and local use taxes on interstate sales.[11]

In the United States, the term electronic commerce or e-commerce encompasses transactions arranged over the Internet but delivered in physical form, as well as digitally delivered commerce. Concern in the interstate sales tax debate largely involves the taxation of goods ordered by phone, mail order, or the Internet, but delivered in tangible form. Many states are less likely to tax digital than tangible commerce. For example, in most states, canned or prewritten software is subject to sales tax if sold in the tangible form of a diskette. If the software is delivered digitally by downloading, 28 states tax the transaction, but 18 states do not. During the Internet tax moratorium, under the ITFA's definition of discriminatory tax, products or services delivered uniquely over the Internet, with no tangible counterpart, may not be taxed by state or local governments.

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[9] Karen Myers, United States Council for International Business, Testimony before the Senate Committee on Foreign Relations, Hearings on U.S. Relations with a Changing Europe: Differing Views on Technology Issues, 108th Cong., 1st sess., June 24, 2003.

[10] Joe Kirwin, "European Commission Defends Digital VAT As Application to Foreign Firms Takes Effect," Bureau of National Affairs, *Daily Tax Report*, No. 127, July 2, 2003, G-5.

[11] See CRS Report RL31929, *Internet Taxation: Issues and Legislation*, by Steven Maguire and Nonna A. Noto.