



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.9.2006
COM(2006) 555 final

Proposal for a

COUNCIL DECISION

authorising the United Kingdom to introduce a special measure derogating from Article 21(1)(a) of Directive 77/388/EEC on the harmonisation of the laws of the Member States relating to turnover taxes

(presented by the Commission)

EXPLANATORY MEMORANDUM

1) CONTEXT OF THE PROPOSAL

- **Grounds for and objectives of the proposal**

Pursuant to Article 27(1) of the Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment, the Council, acting unanimously on a proposal from the Commission, may authorise any Member State to apply special measures for derogation from that Directive in order to simplify the procedure for charging the tax or to prevent certain types of tax evasion.

By letter registered with the Secretariat-General of the Commission on 10 February 2006, the United Kingdom requested authorisation to introduce a measure derogating from Article 21(1)(a) of Directive 77/388/EEC. In accordance with Article 27(2) of Directive 77/388/EEC, the Commission informed the other Member States on 18 July 2006 of the request made by the United Kingdom. By letter dated 19 July 2006, the Commission notified the United Kingdom that it had all the information it considered necessary for appraisal of the request.

- **General context**

As a general rule, Article 21(1)(a) of Directive 77/388/EEC, in the version set out in Article 28(g) thereof, stipulates that, under the internal system, the taxable person supplying goods is liable to pay value added tax (VAT) to the treasury.

The United Kingdom would like to apply a reverse charge procedure, whereby the taxable person to whom the supplies of goods are made becomes the person liable to account for the VAT to the treasury on the supply of the following goods:

- Mobile telephones
- Computer chips/microprocessors/central processing units
- Electronic storage medium for use with computers or any mobile telephone device or specified electronic devices.
- Electronic devices used for the storage, processing or recording of electronic data such as:
 - hand-held digital cameras and camcorders,
 - hand-held digital audio players, such as MP3 players,
 - hand-held digital video players and portable DVD players,
 - wireless devices providing e-mail, telephone, text messaging, web browsing and other wireless data access,
 - hand-held computers,

- handheld or portable positional determination devices for satellite navigation systems,
- games consoles with a screen, or of a kind used with a television or computer.

The consequence of this measure would be that the price paid by the customer to the supplier for such products would not include an amount in respect of VAT. Instead, the customer would account for VAT on the supply in his own VAT return. According to the normal rules, he would also deduct this VAT in the same return. No tax would thus be paid on such supplies between fully taxable persons, and it would be the retailer, the final link in the supply chain, who would pay the whole amount of VAT to the treasury. In this way, the UK wishes to derogate from one of the basic principles of VAT: the system of fractioned payment whereby each taxable person in the supply chain pays a part of the final VAT due on the supply.

- The fraud problem in the United Kingdom

Supplies of the products mentioned above have given rise to a very high level of tax evasion in the United Kingdom. The most common form of evasion consists in the invoicing of supplies by a supplier who is registered for VAT but then disappears without paying tax. In so doing, he nevertheless provides the customer with a valid VAT invoice, allowing the latter to recover input VAT. The result is that the treasury does not receive VAT on the supply, but must give the next trader in the chain credit for input VAT as if it had been paid.

This has developed into Missing Trader Intra-Community Fraud (MTIC), which is a highly sophisticated and well-organised attack on the VAT system, often perpetrated by organised criminals. It exploits an opportunity provided by the transitional VAT regime, under which supplies made by a supplier in one Member State to a customer in another are free of VAT in the State of dispatch. Instead, the customer accounts for VAT in the State of arrival (a reverse charge of the kind already described, but limited to the single supply). Where the customer disappears without accounting for VAT on the supply of high-value items such as those which are the object of the present request, the loss of revenue can be significant. In addition, the persons perpetrating such frauds often organise a series of supplies in which the same goods may circulate several times between Member States (so-called carousel fraud). In this way the amount lost by the treasury may be many times the amount of tax on a single supply of the goods.

Fraud of this kind is estimated to have cost the United Kingdom between GBP 6,750 million and GBP 11,000 million since 2001. In recent years, the United Kingdom has witnessed a significant increase in the sophistication and complexity of the fraud, in response to various interventions. The latest published estimates put MTIC fraud at between GBP 1,120 million and GBP 1,900 million in 2004/05. However, more recently operational indicators in the United Kingdom suggest that levels of fraudulent activity are increasing, despite increased efforts to tackle this type of fraud and the use of the instruments available to all Member States within Community legislation.

In order to combat this criminal activity, the United Kingdom Government would like

to apply a reverse charge procedure. In its view, such a procedure would eliminate the fraud described above by removing the opportunity for profit. If no VAT is charged, there is no scope for the potential 'missing' trader to abscond without accounting to the treasury for the VAT element of the price received from his customer. The procedure would be restricted to the range of goods identified as being the object of most MTIC fraud cases and would have the effect of preventing further significant revenue losses.

Being confined to a small range of goods, the proposed system would not have the character of a generalised reverse charge mechanism, nor would it have the purpose of becoming one. The system would thus not bring any fundamental change to the current VAT system, based on the fractioned payment of the tax.

At the same time, the United Kingdom would also introduce control and reporting obligations to ensure that information is available to provide assurance to the Revenue authorities that the measure is operating effectively. These might be similar to the current reporting requirements for the intra-Community supply of goods.

For the purposes of simplification the United Kingdom would like to set a threshold of GBP 1,000 (approximately €1,480) below which supplies would not be subject to the reverse charge. This would alleviate potential difficulties for retailers and small business customers. At the same time, the threshold should be low enough to avoid disaggregating of sales in order to avoid the reverse charge.

- **The Commission's view of the request**

When the Commission receives requests in accordance with Article 27, it examines these requests to ensure that the basic conditions for granting such requests are fulfilled i.e. whether the proposed **specific measure** simplifies procedures for taxable persons or the tax administration **or** whether the proposal prevents **certain types of tax evasion or avoidance**. In this context, the Commission takes a cautious approach to ensure that derogations do not undermine the operation of the general VAT system. It was in this context that it made the proposal¹ in 2005 for the purpose of amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion and avoidance, and repealing certain Decisions granting derogations which would allow all Member States to apply derogations which had proven to be useful and effective.

In particular, the Commission is normally reluctant to propose acceptance of a request to apply a reverse charge, since such a measure eliminates a central feature of the VAT system, namely fractioned payment. It is true that the special scheme for gold provided for in Article 26*b* of the Sixth VAT Directive could be described as an established reverse charge. However, the application of these provisions are carefully targeted and limited in scope and size.

- **Conclusion**

The request from the UK attempts to use Article 27 for the purpose of making a fundamental change to the VAT system in the sense of a generalised reverse charge,

¹ COM(2005) 89 of 16.3.2005; adopted as Directive 2006/69/EC (OJ L 221, 12.8.2006, p. 9).

even if limited to a certain range of goods. It would mean that taxable persons in the sectors concerned would effectively have to deal with three different types of tax regime:

- The “classical” VAT system
- The reverse charge system for B2B supplies where certain criteria were fulfilled
- The intra-Community system.

This would add an extra layer of difficulty to the accounting burdens already faced by business. Similarly, additional compliance burdens (verifying the nature of customers and reporting transactions) would be imposed on all businesses, including honest traders, operating in the areas concerned. Furthermore, the application of the reverse charge would offer new fraud opportunities especially at the final consumption level and would therefore need to be accompanied by appropriate control measures in order to guarantee that final consumption will not escape taxation in the absence of a properly functioning fractioned payment system.

While recognizing these drawbacks the Commission nevertheless believes that the requests can still be regarded as satisfying **the test required by Article 27**. In fact the measure is likely to eliminate the currently experienced MTIC fraud situations and thus addresses a specific type of fraud. The question, however, arises to what extent the measure remains proportional having regard to the relationship between the size of the fraud and non-fraudulent activity in the sector concerned. The scope of the measure is relatively broad, covering a large proportion of the electronic sector, but according to the information received from the United Kingdom the number of taxpayers concerned by the measure and the economic importance of their activities remains limited (some 22,500 taxable persons out of a total of 1,900,000 VAT registered businesses). In view of the huge amounts of VAT receipts at stake and the relatively limited increase in burdens for the legitimate trade a broad scope of application still appears to remain within the scope of Article 27.

At the same time it must be recognized that other Member States experience similar fraud patterns (involving the same categories or other types of goods) and that they may seek similar derogations from Article 21 of the Sixth Directive. That could result in a variety of different obligations for taxpayers in different Member States, a situation which would conflict with the requirements for a well functioning Internal Market. Therefore, the proposal granting the requested derogation must also define the key elements of the implementation of the reverse charge and must limit its duration in time in order to allow for an evaluation of its effectiveness (both as regards stated MTIC fraud and in preventing final consumption without VAT payment) and its impact on the functioning of the Internal Market. The proposal allows for the authorisation of the reverse charge until 31st December 2009.

- **Existing provisions in the area of the proposal**

There are no existing provisions in the area of the proposal.

- **Consistency with other policies and objectives of the Union**

The proposal is consistent with the overall objective to help Member States to combat fiscal fraud.

2) CONSULTATION OF INTERESTED PARTIES AND IMPACT ASSESSMENT

- **Consultation of interested parties**

Not relevant.

- **Collection and use of expertise**

There was no need for external expertise.

- **Impact assessment**

The Decision proposal aims at combating VAT evasion and is likely to have a positive impact on VAT receipts.

Nevertheless, the measure will have a negative impact on businesses since the arrangements will be different from those applying for normal supplies of goods. This will introduce complexity in accounting for businesses which do not deal exclusively in the goods which are the object of the derogation. The control mechanisms envisaged will also impose additional obligations on the business sector concerned. It is therefore clear that this derogation fails the simplification test provided by Article 27 and only falls within the scope of preventing specific types of evasion.

There is, of course, no guarantee that the measure envisaged by the UK will eliminate the fraud in question, which is why the Commission proposes a short time-scale for the derogation.

While the impact of the measure will in any case be limited because of its scope, the effectiveness of the measures will be evaluated by the UK and communicated to the Commission.

3) LEGAL ELEMENTS OF THE PROPOSAL

- **Summary of the proposed action**

Authorisation for the United Kingdom to apply a measure derogating from Article 21(1)(a) of the Sixth Council Directive 77/388/EEC as regards the use of a reverse charge mechanism for domestic supplies of mobile telephones, computer chips/microprocessors, electronic storage media & handheld electronic devices used for the storage, processing or recording of electronic data.

- **Legal basis**

Article 27(1) of the Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment

- **Subsidiarity principle**

The proposal falls under the exclusive competence of the Community. The subsidiarity principle therefore does not apply.

- **Proportionality principle**

The proposal complies with the proportionality principle for the following reason(s).

This Decision concerns an authorisation granted to a Member State upon its own request and does not constitute any obligation.

Given the clearly defined scope of the derogation, the special measure appears to be proportionate to the aim pursued considering the scale and size of the losses concerned.

- **Choice of instruments**

Proposed instruments: other.

Other means would not be adequate for the following reason(s).

Under Article 27 of the Sixth Council Directive 77/388/EEC on the harmonisation of the laws of the Member States relating to turnover taxes, derogation from the common VAT rules is only possible on the authority of the Council acting unanimously on a proposal from the Commission. A Council Decision is the only suitable instrument since it can be addressed to an individual Member State.

4) **BUDGETARY IMPLICATION**

The proposal has no negative implication for the Community budget.

5) **ADDITIONAL INFORMATION**

- **Review/revision/sunset clause**

The proposal includes a sunset clause.

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to the Sixth Council Directive 77/388/CEE of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment², and in particular Article 27(1) thereof,

Having regard to the proposal from the Commission³,

Whereas:

- (1) In a letter registered by the Secretariat-General of the Commission on 10 February 2006, the United Kingdom requested authorisation to introduce a special measure derogating from Article 21(1)(a) of Directive 77/388/EEC as regards the person liable for payment of value added tax (VAT).
- (2) In accordance with Article 27(2) of Directive 77/388/EEC, the Commission informed the other Member States by letter dated 18 July 2006 of the request made by the United Kingdom. By letter dated 19 July 2006, the Commission notified the United Kingdom that it had all the information it considered necessary for appraisal of the request.
- (3) The person liable for payment of the value added tax (VAT), under Article 21(1)(a) of Directive 77/388/EEC, in the version set out in Article 28g thereof, is the taxable person supplying the goods. The purpose of the derogation requested by the United Kingdom is to place that liability on the taxable person to whom the supplies are made, but only under certain conditions and exclusively in the case of mobile telephones, computer chips/microprocessors, electronic storage media and handheld electronic devices used for the storage, processing or recording of electronic data.
- (4) Within that sector, a significant number of traders engage in tax evasion by not paying VAT to the tax authorities after selling the products. Their customers, however, being in receipt of a valid invoice, remain entitled to a tax deduction. In its most aggressive form, the same goods are, via a 'carousel' scheme, supplied several times without

² OJ L 145, 13.6.1977, p.1. Directive last amended by Directive 2006/69/EC (OJ L 221, 12.8.2006, p. 9).

³ OJ C , , p. .

payment of the VAT to the tax authorities. By designating in those cases the person to whom the goods are supplied as the person liable for the VAT, the derogation would remove the opportunity to engage in that form of tax evasion. However, it would not affect the amount of VAT due.

- (5) For the purposes of ensuring the effective operation of the derogation and preventing the tax evasion from being shifted to other products or towards the retail level, the United Kingdom should introduce appropriate control and reporting obligations. The Commission should be informed of the specific measures adopted, and the monitoring and overall evaluation of the operation of the derogation.
- (6) The measure is proportionate to the objectives pursued since it is not intended to apply generally, but only to a specific high risk sector comprising certain carefully defined products in relation to which the scale and size of the tax evasion has resulted in considerable tax losses. Furthermore, since that sector is a small one, the derogation cannot be considered equivalent to a general measure.
- (7) The authorisation should be valid only for a short period, because it cannot be ascertained with certainty that the objectives of the measure will be achieved, nor can the impact of the measure on the functioning of the VAT system in the United Kingdom and in other Member States be gauged in advance; moreover, the impact of the measure and its implementation on the functioning of the internal market will have to be properly assessed.
- (8) The derogation has no negative impact on the Community's own resources accruing from VAT,

HAS ADOPTED THIS DECISION:

Article 1

By way of derogation from Article 21(1)(a) of Directive 77/388/EEC, in the version set out in Article 28g thereof, the United Kingdom is authorised to designate the taxable person to whom the supplies of the following goods are made as the person liable to pay value added tax (VAT):

- (1) mobile telephones, being devices made or adapted for use in connection with a licensed network and operated on specified frequencies, whether or not they have any other use;
- (2) integrated circuit devices such as microprocessors and central processing units in a state prior to integration into end user products;
- (3) electronic storage medium and PC cards, such as Memory Sticks, CD-Rom & SD cards, for use with computers or with any of the devices referred to in points (1) and (4);
- (4) electronic devices used for the storage, processing or recording of electronic data as follows:
 - (a) handheld devices for recording or playing of sound and/or images;

- (b) handheld digital audio players, such as MP3 players;
- (c) handheld digital video players and portable DVD players;
- (d) wireless devices providing e-mail, telephone, text messaging, web browsing and other wireless data access, and hand-held computers;
- (e) handheld or portable positional determination devices for satellite navigation systems
- (f) games consoles with a screen, or of a kind used with a television or computer.

The derogation shall apply in respect of supplies of goods for which the taxable amount is equal to or higher than GBP 1 000.

Article 2

The derogation provided for in Article 1 is subject to the United Kingdom introducing appropriate and effective control and reporting obligations on taxable persons that supply goods to which the reverse charge applies in accordance with this Decision.

Article 3

The United Kingdom shall inform the Commission where it has adopted the measures referred to in Articles 1 and 2 and shall by 31 December 2008 submit a report to the Commission on the overall evaluation of the operation of the measures concerned, in particular as regards the effectiveness of the measure and any evidence of the shifting of tax evasion to other products or to the retail level.

Article 4

This Decision shall expire on 31 December 2009.

Article 5

This Decision is addressed to the United Kingdom of Great Britain and Northern Ireland.

Done at Brussels,

*For the Council
The President*