SOURCES OF COMPLEXITY IN THE VALUE ADDED TAX: A EUROPEAN PERSPECTIVE

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INTRODUCTION

THE TEXTBOOK ANALYSIS OF THE VALUE ADDED tax (VAT) usually presents the following as advantages of this tax: it is self-enforcing, it is simple (at least when compared to the income tax) and, because it is usually included in the price of goods and services, taxpayers are less resistant prone to its use. In the United States, the VAT is usually discussed as an alternative way of raising revenue (eventually replacing income taxation) or, in the European way, as a tax that can be combined with income taxation of individuals and corporations. (See Slemrod and Bakija, 2004; President´s Advisory Panel on Tax Reform, 2005).

Although U.S. tax experts point to the fact that, in practice, the simplicity of the VAT is not as clear cut as its textbook version (Gale, 1997), I venture that a European perspective can be helpful in highlighting some of the main sources of the VAT´s complexity. The purpose of this paper is to analyze several sources of complexity from a conceptual point of view and to also provide some examples.

The paper is organized as follows: the second section presents a brief characterization of the VAT functioning in the European Union (EU); the third section deals with the problems caused by a multiple rate structure; the fourth section explores the sources of complexity emerging from exempt activities, the partial right of deduction and the *pro rata* mechanism; the fifth section analyzes the rules concerning location of services; the sixth section concludes by presenting some tentative reflections on the EU experience applying the VAT and what the United States can learn from this system.

THE VALUE ADDED TAX IN THE EU: A BRIEF CHARACTERIZATION

Tax harmonization in the area of indirect taxation was an important goal at the very beginning of the European project, but the unanimity rule put some strain on the final agreements to be reached on this matter.

The legal instrument used to implement tax harmonization in the EU has been the Directive.[1] Using this instrument, the European Council issued the First Directive[2] in 1967 concerning turnover taxes, which established the VAT as a replacement to the then existing systems of turnover taxes.

The VAT enacted in the First Directive had the following characteristics:

- It involved the application of a general tax on consumption of goods and services proportional to their price.
- The number of transactions taking place in the production and distribution process did not affect the tax burden. This was achieved by the credit mechanism, which allows the deduction of the VAT included in the purchase price of inputs (credit method or indirect subtractive method).
- Each taxpayer is a collector of the VAT. Tax due is the difference between charged VAT and deductible VAT. The final consumer ultimately bears the full amount of the VAT.
- The VAT would be charged on imports, and exports would be zero rated, thus giving exporters a refund of the supported VAT in inputs (destination principle).

The deduction mechanism ensures that the number of stages in the production of a good or a service has no impact on the tax burden. This feature is a clear advantage over sales taxes operating in cascade, where the tax burden is dependent on the organization of the production and distribution processes. This non-distorting feature of the VAT at domestic level is also very important to ensure neutrality in international trade. By exempting exports (with reimbursement of the VAT included in inputs), and by taxing imports at customs entry, the VAT ensured a tax-leveled playing field for international trade by European countries, which was (and still is) a sensitive issue in economic policy.

Another often mentioned advantage of the VAT is its self-enforcement nature. By allowing deduction of the supported VAT, each taxpayer would be interested in asking for proper invoicing from its suppliers.

One of the reasons contributing to the simplicity of the VAT – at least in comparison to the usual application of the income tax – is the fact that exemption for small businesses takes a significant number of agents out of the VAT. In this case, exempt businesses act as final consumers. They do not charge the VAT, but they also do not deduct it. And, as the value added by this group of taxpayers is not high, the effect in tax receipts is marginal, in comparison to the gains from simplicity in its application.

As the European project evolved, the White Paper on the Internal Market (1985) established an agenda for the creation of a European Single Market. In this new setting, goods would circulate in a unified tax jurisdiction. The concept of exports and imports between EU countries was abolished for VAT purposes, giving rise to the concept of intra-communitary transactions. The European Commission proposed a switch to a system where operations would be taxed in their country of origin, but the VAT revenues would be redistributed between member states, to preserve the existing pattern of VAT receipts. After complex negotiations, Directives 680/91 and 111/92 were issued, creating a "transitory system," where the destination system, but without custom tax controls, was maintained for a certain period. (This supposed "transitory system" is still in place, although it was meant to be changed to an origin system in 1996.) These are, in a very rough and synthetic way, the cornerstones of the European VAT system.

However lengthy and complex the process of harmonizing the VAT in EU countries may have been, it is undeniable that the VAT has been a "revenue machine" for most governments.

As Table 1 shows, in some EU countries, general consumption taxation under the VAT generates revenues similar to the personal income tax. The significant difference of EU countries, relative to the United States and Japan in terms of general consumption tax revenues, is also clear.

At a conceptual level, the VAT has a self-enforcement nature, promotes neutrality in trade and is simpler than the income tax; and it raises a high amount of revenue, given that it is a general consumption tax. In practice, however, the real world VAT used in the EU is far from conforming to this model. What then are the main causes that complicate the VAT operation in EU countries? Generally speaking, the main distorting factor is the number of deviations from the "ideal" VAT that legislation in each country usually includes (Slemrod and Bakija, 2004).

The most important sources of complexity in the EU value added tax systems are:

1. The existence of multiple rates,
2. The existence of several exemptions and its effect on taxpayers with exempt and subject operations – "mixed operations,"
3. Exclusions to the right of deduction,
4. Transitional rules, mainly in the area of intra-EU trade,
5. The taxation of services, given the immaterial nature of them, and the difficulties of assigning its fulfillment to a certain tax jurisdiction.

Table 1

Tax revenues of major taxes as a percentage of total tax revenue in some OECD countries, 2002

	Personal income	*Corporate income*	*Social security and other payroll*	*Property*	*Goods and services*	*Of which: General consumption*
Denmark	53.2	5.8	3.9	3.5	33.1	19.9
Finland	31.2	9.3	26.6	2.4	30.2	18.2
France	17.3	6.6	39.5	7.5	25.4	16.7
Germany	25.1	2.9	40.3	2.3	29.2	18.0
Italy	25.5	7.6	29.4	5.1	26.9	15.0
Portugal	17.9	10.8	27.0	3.1	40.0	24.0
Spain	19.4	9.1	35.3	6.6	28.6	16.6
United Kingdom	29.8	8.1	17.0	12.0	32.7	19.4
Japan	18.4	12.2	38.3	10.8	20.1	9.5
United States	37.7	6.7	26.1	11.9	17.6	8.2
OECD Total Unweighted	25.7	9.4	26.3	5.5	31.9	18.9

Source: OECD (2005:17).

MULTIPLE RATES

In the EU, reduced rates are usually a feature of the VAT operation. Rates applying in some EU countries are presented in Table 2.

With the exception of Denmark (and Slovakia), multiple rates exist in every other country in the EU. In many cases there are two rates lower then the standard one. Three points are worth discussing concerning reduced rates. What are the reasons for the existence of reduced rates, given that a single rate VAT is usually presented as the "ideal model"? What rules do EU Directives establish on the possibility of multiple VAT rates? What complexities do arise from multiple VAT rates?

The existence of reduced VAT rates is usually grounded in socioeconomic motives (Farmer and Lyal, 1995). At the social level, there is the objective of reducing the tax burden on goods and services deemed basic or essential. This rests on the assumption that certain essential items, such as food, represent, for lower income persons, a higher share of consumption expenses. The use of a reduced rate would thus avoid the regressiveness that a standard rate would entail. In other cases, such as the reduced rate for books or newspapers, a social interest in promoting (or at least, not hindering by taxation) these merit goods is seen as a strong enough motive for applying a reduced tax. Still, in other goods or services, economic considerations prevail to apply a reduced rate. It is, for example, the case of services with a "*high labor component*," such as some building or repair services. Here, the reduced tax is seen as a tool to fight unemployment.

The sixth Directive contained few provisions on tax rates. It did not establish a standard rate and also did not lay down guidelines about reduced rates. Member states had a significant degree of freedom in establishing standard and reduced rates. Naturally, a high variation in standard or reduced rates between geographically close member states could distort trade patterns. This would, in principle, act as a deterrent to significant differences in tax rates among member states. However, the practice has not conformed to this supposition. Looking at Table 1, and comparing, for example, rates in Germany and Denmark, or Spain and Portugal, they appear to diverge enough to induce a lot of tax motivated cross-border trade.[3] Apparently, the fact that several EU reports found no conclusive evidence of distortions in trade and competition between member states seems to be the main reason for the prevalence of this state of affairs regarding VAT tax differentials.

Table 2
VAT rates in some EU countries, 09-01-2006

	Standard rate	*Reduced rates*
Denmark	25%	-
Finland	22%	8%; 17%
France	19.6%	2%; 5.5%
Germany	16%	7%
Italy	20%	4%; 10%
Portugal	21%	5%; 12%
Spain	16%	4%; 7%
United Kingdom	17.5%	5%

Source: OECD.

Recently, few, if any, advances have been made to move forward to an ideal model of a single, uniform, VAT rate. In 1995 the EU Commission drafted a Directive Proposal where a maximum VAT rate of 25 percent was introduced. It was rejected by the EU council, which decided to take efforts to guarantee that the 10 percent points existing between the highest and lowest EU VAT standard rates would not be increased.

In 2003, a proposal was presented to modify the set of reduced rates, introducing some degree of harmonization. To this day, no visible result has been achieved. Multiple rates of VAT thus seem a factor that taxable persons have to live with. What complexities arise from their application? Two main sources of complexity can arise.

First, the legal battles and lawsuits resulting from the fact that the member states legislation on reduced VAT rates is sometimes not in accordance with the (amended) Sixth Directive. Member states, sometimes trying to ease the tax burden on certain goods or services, include in the reduced rate lists goods or services that violate EU legislation. Two examples illustrate this point.

The European Court of Justice ruled that the Spanish government was not complying with the Sixth Directive rules when highway tolls were taxed a 5 percent.[4] Those rules stated that the 5 percent could be applied to a "service consisting of the transportation of people and their luggage." The Court ruled that a highway toll does not constitute payment for that type of service, but rather "allowing people who already have transportation means to travel with increased convenience and safety." The 5 percent rate applied to that service was not in accordance with EU rules, and had to be changed.

In another case, the court ruled that the Portuguese government was not complying with the Sixth Directive when table wines (*vinhos comuns*) were taxed a 5 percent.[5] Articles 12 and 28 of the Sixth Directive forbid a rate lower than 12 percent. The Portuguese government, with the inevitable protest of some wine growers, had to change the rate to 12 percent.

The second source of complexity arises from the inevitable doubts that can happen when a taxpayer (or a tax inspector) must decide if a certain good or a service is included in the legal lists of goods/services taxed at reduced rates. An example illustrates the potential sources of uncertainty in applying reduced rate. The Portuguese VAT code has two lists of goods/services to which the rates of 5 percent and 12 percent are applicable. List I (5%) has an item (1.12) that is defined as:

> "*Fruit juices, fruit nectars or juices of horticultural products, including juice sirops, and concentrated juices*".

Given this definition, is a soya bean based drink taxed at 5 percent?

In 2005, and after some difficult questions presented by taxpayers who were in the business of selling soft drinks, a ruling (*oficio circulado*) issued by the Portuguese tax administration said that the 5 percent rate was applicable to soya bean juice. These rulings are mandatory to the tax authority officials, but they can by challenged by taxpayers. If the conclusion had been the opposite, it is easily conceivable that a soya bean based drink producer and the tax authorities could be locked into a legal battle dragging on for years.

Looking into the lists of goods and services to which reduced rates are applicable, a great room for confrontation between taxpayers and tax authorities can surely be found, especially when tax authorities try to forbid some "broad interpretation" by taxpayers of goods and services subject to reduced rates. As the inventiveness of firms knows no boundaries, and some preferential tax treatment in the form of a reduced VAT rate is an advantage relative to potential product competition taxed at a standard rate, it is easily imaginable the amount of complex questions that taxpayers, tax authorities, tax consultants, and courts have to deal with regarding multiple rates of VAT.

THE RIGHT OF DEDUCTION AND FIRMS WITH MULTIPLE ACTIVITIES

The application of the VAT is straightforward in the case of a taxable person developing an activity subject to the tax. In this case, provided that no particular problems related to the right of deduction arise from the fact that inputs are used for nonbusiness purposes, the computation of VAT due is simple. But considerable complexities can be found in situations where a taxpayer develops multiple activities. To analyze this point, I will first mention the legal framework put in place by the European Directives, and then illustrate its application with an example.[6]

The right of deduction – a crucial feature of the VAT neutrality, as previously shown – is regulated in detail in articles 17 to 20 of the Sixth Directive.

Article 17 main rules concerning the right of deduction of the VAT included in inputs are:

1. When the inputs are used to produce taxable goods or services, the VAT is fully deductible – art. 17, nº 2.
2. When the inputs are used to produce goods or services under a complete exemption – usually related to international trade, where the seller's exemption (zero rate) coexists with the right of deduction – the VAT is also fully deductible – art. 17, nº 3.
3. When an input is miscellaneously used in taxable and exempt operations (i.e., non-complete exemption which, as it is well known, preclude the right of deduction), the VAT is deductible proportionally to the use of input in taxable operations – art. 17, nº 5.

In this latter case, the algorithm of a *pro rata* (percentage of deduction) is established in article 19 of the Sixth Directive. The *pro rata* is obtained by dividing the amount of operations that allow VAT deduction by the total amount of operations of a taxpayer.[7]

Three aspects here are worth noting. The first is that the use of *pro rata* is not dependent on the taxpayer carrying out taxable and (non-complete) exempt operations. A VAT taxpayer can carry both types of activities and, by being able to separate precisely what inputs are used in each activity, fully deduct the VAT included in the price of the inputs used in the taxable operations, and forgo the right of deduction of the VAT included in the price of the inputs used in the exempt operations. Therefore, the *pro rata* method is not subjectively dependent on the characteristics of the taxpayer's mix of activities. It is an objective mechanism to sort out the (sometimes rather complex) task of imputation of VAT charged by suppliers to taxable and exempt operations. In this respect, some European VAT codes are not in accordance with the Sixth Directive. In particular, the Portuguese solution, by adopting the subjective approach can cause some distortions in the competitive conditions of firms.[8]

The second aspect is closely related to the one just mentioned. The *pro rata* is a "residual option," and its use is dependent on the impossibility of a clear identification of the use of inputs between different operations. Even then, EU legislators fearing that the use of *pro rata* could result in significant distortions of competition, provided in the Sixth Directive other imputation mechanisms, such as "real imputation" a "sectoral *pro rata*."

Finally, it must be explained why the indiscriminated or non-disciplined use of the *pro rata* could produce significant distortions in economic activity, which is part of a general problem resulting from VAT non-complete exemptions. When a taxpayer carries out operations under this type of exemptions, he is placed in the position of a final consumer. The deduction chain is broken and double taxation may arise. It thus represents a break from the normal operation of the VAT. A non-complete exempted operation, placed in the middle of an economic circuit, has disruptive effects. The elimination of the right of deduction at that point has important repercussions, changing the price of goods or services relative to a situation where full deduction applies.[9]

To show the potential pitfalls of the *pro rata*, let us suppose that a bank purchases a computer for 1 million euro, plus a 20 percent VAT. The bank has a 720 million euros exempt turnover, and 80 million euros taxable turnover.[10] Under a *pro rata* method – which can be used when the bank is not able to clearly separate the computer utilization in exempt and subject activities - the deductible VAT in the purchase of the computer is

$$\left(\frac{80}{720+80}\right) \times 200\ 000 = 20\ 000.$$

Supposing that the real use of the computer is 3 percent in taxable operations and 97 percent in non-taxable operations, it should deduct only 3 percent × 200,000 = 6,000. Other scenarios (advantageous to the bank or to the state) can be imagined, depending on the effective use of the computer.

For firms with multiple activities and big turnover, a small variation in the *pro rata* can have serious consequences in terms of deductible VAT. Companies are tempted to use every possible way to increase the *pro rata*. Understandably, this is an area where disagreements can frequently happen between firms and tax authorities.

A classical case of conflict between companies and tax authorities across the EU concerns the right of deduction in holding companies.[11] To illustrate how it can happen, imagine a holding company (H) that performs two functions: receives dividend income of its subsidiaries (H_1 and H_2), and also performs management related activities, such as financial and tax advice to them.

A first question arising from this business arrangement concerns the status of the dividend receiving activity regarding the VAT. Is it a taxable activity, an exempt activity, or does it fall outside the scope of the VAT? The Sixth Directive is not clear cut on the issue. Based on article 4, n° 1 and 2, the European Court of Justice (ECJ) ruled, in two famous cases,[12] that share dividends received by a holding company do not constitute an economic activity in terms of the VAT. If dividend receiving activities fall outside the scope of the VAT, then no right of deduction arises for the tax included in inputs directly used for that activity.

But given that the *pro rata* is computed as a fraction that includes in the numerator the amount of operations that allow VAT deduction and the amount of all operations in the denominator, the ECJ had to clarify some issues, especially concerning what is to be included in the denominator. For the aforementioned type of holding companies, whether dividends are included or not in the *pro rata's* denominator is very important. If they are, the *pro rata* is reduced, and the nondeductible VAT is a borne cost by the holding company. The problem is quite relevant for holdings that perform (taxable) management related activities to its subsidiaries, and the amount of deductible tax they can subtract from the charged VAT. The ECJ ruled that the logical consequence of dividends falling outside the scope of tax is that they are not included in the *pro rata's* denominator.[13]

Naturally, that a strict application of the *pro rata* rule as a residual mechanism to compute deductible VAT can be quite complex. The previous operations of separating what inputs are clearly related to taxable and exempt operations, and the consequent identification of the miscellaneous inputs must rely, especially in big organizations with several activities, in management accounting systems. It is easily imagined the "fine tuning" that is needed for a strictly correct application of the *pro rata*. In this sense, it could be argued that the Portuguese legislative solution, although not in harmony with EU legislation, can be seen in the light of a choice between efficiency and simplicity. The objective use of *pro rata* -- using it related to the type of operations as a residual mechanism to regulate the right of deduction in the case of miscellaneous inputs – minimizes economic distortions caused by the interruption of the deduction right; but the subjective use of the VAT (the Portuguese solution) by relating it to the taxpayer conditions of a mix operator with taxable and exempt operations, although less efficient, is simpler in its application.

Still concerning the right of deduction, but independently of the *pro rata* mechanism, another issue related to the complexity in applying the VAT can be highlighted: the exclusion of the right of deduction to certain inputs.[14]

In business life it is well known that certain categories of paid expenses are not business related but have a luxury, amusement, or entertainment nature. In this case the firm supporting these expenses is treated like a final consumer, and the right of deduction is disallowed. Such an important matter is regulated in article 17, nº 6 of the Sixth Directive. It establishes that expenses that do not have a strictly business nature, such as sumptuary, recreative, or representation expenses, will not allow the right of the VAT deduction.

Each national VAT code has to enumerate more precisely what type of expenses do not give rise to the right of deduction. And, in this process of adaption of article 17, nº 6, some problems may arise.[15]

In the Ampafrance case,[16] the ECJ was confronted with a situation where the French tax authorities denied (under the French VAT rules) the deduction of supported VAT by the Ampafrance company in receptions, restaurants, and shows. The French government argued that it was impossible to distinguish the business or private nature of these expenses. The exclusion of the right of deduction was thus, in the view of the French state, an important instrument against tax evasion. The company argued that the business nature of the expenses was clear and proven. The court ruled that the right of deduction could not be denied when it could be objectively demonstrated that the expenses had a business purpose. Therefore, not the type of expense but its business or private nature should govern the exercise to the right of deduction.

But it is quite complex, in some cases, to clearly separate the business or nonbusiness purpose of certain expenses; and, accordingly, to settle for the deduction or non-deduction of the VAT supported in such items.

VAT AND INTRA-EUROPEAN TRADE OF GOODS AND SERVICES

The present rules of taxation of trade in goods and services between EU member states, under the VAT were laid down in Directives 91/680 and 92/111. The Sixth Directive was thus amended to integrate new dispositions. The reason for such changes was the abolition of tax frontiers within the then European Community, because they were deemed incompatible with the Single Market.

The European Commission proposed to replace the system in place at that time – where trade between member states was treated as exports and imports – with a system based in the "origin principle." In this new proposed system, trade of goods between member states would originate a new taxable operation, called "intra-communitary transaction." The VAT would cease to be refunded on "exports" – which would, afterwards, be VAT subject intra-communitary sales – and buyers who were taxable persons would be allowed to deduct the tax supported in these acquisitions. With this mechanism, intra-EU trade was to be treated as single-state transaction.

In typical political compromising, the Commission also proposed a compensation mechanism that ensured that, although the tax would be changed under an "origin-based" system, the tax revenue would still be distributed according to the final consumption (i.e., destination-principle). This would, supposedly, soften the importing countries resistance to such a change in the VAT operation across EU. Following complex negotiations, a "transitory regime" was put in place by the two previously mentioned Directives. The system can be characterized as follows:[17]

1. Trade of goods between taxable persons in member states continues to be taxed in the destination country. The seller has a complete exemption, and is refunded the VAT he can deduct from inputs. The buyer registers the acquisition in his VAT return, and is liable for the VAT. This amount is, consequently, deductible tax for the buyer, unless it is subject to the *pro rata* rule.
2. Final consumers have, in principle, freedom to buy from other EU countries, paying the VAT at the origin. But important exceptions apply, such as:
   - new means of transportation,
   - distance sales,
   - purchases made by exempt persons and by nontaxable legal entities.

These exceptions – also subject to some qualifications in the form of thresholds - mean that the destination principle still applies, when final consumers make such acquisitions.

To guarantee a significant degree of control, intra-EU transactions must be made with fiscal identification numbers, and intensive cooperation between tax authorities is needed. A system of information exchange (VIES - VAT information exchange system) is in place, which is based on a European network of VAT central computer systems.

Compared with a pure-based "origin system," like the one initially proposed by the Commission, the system briefly described is cleary more cumbersome. Its administrative, compliance costs, and legal complexity are significantly higher, and it has been prone to schemes of tax fraud.

One of the most notorious is the so-called "carousel fraud." The scheme begins when company A, supposedely located in country 2, sells a good to company B, located in country 1. Company A does not charge the VAT to B, and B charges and deducts the VAT itself. B then sells to C, and, as it is an internal operation (in country 1), B charges the VAT to C. At this point, B should pay to the state the amount of the VAT charged to C. But B is a missing trader, that is usually a fictitious company, or one with a minimal structure, and eventually has no mail address, appearing and disappearing at will. Therefore, no VAT due is paid to the state, because B places itself outside the legal circuit of VAT operations. Then C deducts the VAT that B charged; and, subsequently, charges the VAT to D, paying the difference to the State. Then D makes an intra-EU transaction to A, and asks for the refund of the VAT that C charged. Then A does another intra-EU transaction to B or to an operator with similar characteristics. The fraud is again in motion like a carousel. Only when the tax authorities uncover it can the scheme be stopped. The fraud implies a loss to the state, equal to the VAT that B receives and does not pay.[18]

Looking now to the taxation of services, the rules applying can be summarized as follows:

1. As a general rule, for VAT purposes, services are located, and taxed, where the supplier has established his business or has a permanent establishment from which the service is rendered.

However, this general rule has to give way to many special treatments of several types of service transactions. In practice, thus, the general rule is applied only when the specific service is not singled out for special treatment under any of the exceptions. The rule has to give way to the exceptions, and has a residual application.

2. A set of exceptions refers to the following services:
   - Services connected with immovable property are located where the property is located.
   - Transport services are located where the transport takes place.[19]
   - Services connected with cultural, artistic, sport, educational, or similar, are located where they are rendered.
   - Works on movable tangible goods and ancillary transport services are taxed where they are performed.

Thus, if in the general rule the place of establishment of the seller is the defining factor, in the exceptions just mentioned, the place of execution is singled out as the relevant nexus for the tax.

3. Another important set of rules concerning the taxation services is applied to the following operations:
   - advertising,
   - transfers and assignments of intellectual and commercial property rights,

- professional and consulting services (like those from economists, lawyers, engineers), data processing, and information,
- temporary work,
- banking, financing, and insurance operations,
- refraining of exercising on activity of the above list,
- leasing of movable assets, with the exception of transportation equipment
- telecommunications and e-commerce.

In the case of the services just mentioned, if the acquirer is a final consumer, located in an EU country, the VAT is charged by the supplier, because the general rule applies. If, on the other hand, the acquirer is a VAT registered person, a reverse charge mechanism applies and the acquirer is the taxable person, which has also the right to deduct the VAT.

Why such a detailed and complex set of rules? The legislative process that produced these solutions helps to understand some of the arrangements. According to Farmer and Lyal (1995:155), the original proposal of the Directive had a rule (taxation at the supplier country) with the only exception being services related to immovable property. It was argued that simplicity of procedure and the advantages of avoiding the application of concepts like "place of utilization" favored such a solution. But the proposed Directive itself already contained an important exception: in the case of services similar to the ones listed in 3 above, a zero rate, with a VAT refund, was granted if the customer was a taxable person. The Commission stated that, in the case of services which are very commonly object of international trade, a pure origin-based taxation would produce an undesirable effect: it would place EU firms on a disadvantage against nonmember suppliers and, inside EU, would had to competitive distortions given the disparities between VAT rates. The final text of the Directive thus enacted the rules mentioned in 1 to 3 above.[20]

Besides the complexities arising from the application of those rules and exceptions to real world operations, legal conflicts can arise between EU states and the taxpayers. The ECJ has been producing some rulings on cases where the complexity of VAT taxation of services are quite illustrative of the problems arising from the application of these rules and exceptions. In processing C-429/97, the court was presented with the following case: should a garbage collection service firm be taxed under the general rule according to which it is taxed when the supplier is located, or is it an exception under the second set previously presented, because the service can be classified as a "work on movable tangible goods"? The court, duly recognizing the complexity of the case (Cunha, 2004:159) decided in favor of the first alternative.

In another case, the ECJ was presented with a situation that involved the services of a professor from a German University to the International Chamber of Commerce, located in Paris. The service related to an arbitrage in a dispute between two agents. As lawyer's services are included in the third set of exceptions, the court had to decide if an arbitrage service is included in the definition (which would imply that if the customer is a VAT taxable person the reverse charge mechanism must be used), or if that kind of service is not included in a lawyer's activities, in which case the general rule – taxation in the place of the seller's location – applies. The court ruled in favor of the second alternative.

The difficulties arising from services have a great contribution from the fact that services are immaterial, and therefore less controllable than goods. The political compromises in the area of service taxation under the VAT, by trying to combine the origin rule with the ever-growing international trade in services between taxable persons, produced some delicate solutions that constitute, undoubtedly, one of the most complex areas of the VAT application in the EU.

CONCLUSION: THE EU EXPERIENCE AND ITS LESSONS FOR THE POTENTIAL ADOPTION OF THE VAT IN THE UNITED STATES

Based on the EU experience, what are, in my view, the main lessons that can be drawn for a potential future introduction of the VAT in the United States? First, the definition of the architecture of the tax will be easier than in the EU, given that the unanimity rule is not the overwhelming factor it is in the EU tax deliberations. On the other hand, some spillovers of the U.S. legislative process can also affect the outcome of tax design. The single or multiple rate structure is one of the more "lobbying prone" basic tenets of a VAT code. Even if social or political reasons prevent the goal of a single tax, the number of goods and services subject to reduced rates should be kept to a minimum.

As fas as incomplete exemptions are concerned, the same objective should apply: they should be minimized because they introduce complexity and are sources of inefficiency. When they exist, the *pro rata* mechanism can be applied under a personal or activity based rule. The activity based rule is more in accordance with the logic of the VAT, but probably a personal based rule creates less difficulties for taxpayers, because they do not have to identify miscellaneous inputs and deduct their VAT according to the *pro rata* of the taxpayer.

Regarding the right of deduction for specific types of nonbusiness related expenses, the solution of allowing the VAT deduction when expenses are accepted for income tax purposes looks like a sensible one.

Reimbursement of the VAT to exporters or to high-investment firms is also a sensitive area: they should be processed without long delays and audits to check its true nature should be frequent. In addition, cross-checking sales and purchases for income tax purposes with VAT records on deductible and charged values is a crucial aspect of fraud preventing by tax authorities.

Notes

[1] Directives, as it is well known, lay down the objectives to be achieved and leave to the national governments the choice of legal instruments to promote them. Regulations, on the other hand, are binding to member states in their entirety.

[2] Directive 227/67.

[3] In the case of Germany and Denmark, special arrangements were agreed to prevent this. Cross-border controls still happen.

[4] Process C-83/99.

[5] Process C-276/98.

[6] See Farmer and Lyal (1995) and Basto and Oliveira (2001) for extensive treatment of this topic.

[7] As I will point out later, there are some qualifications to the components of this formula.

[8] See Ministério das Finanças (2006), especially the chapter on the VAT.

[9] Note that the tax yield increases if the exemption is previous to the final step of the economic circuit.

[10] In banking and financial services the core business is usually exempt, but some some activities (e.g. wealth management) are subject to the VAT. The VAT treatment of the financial services is a complex question in every country that applies the VAT.

[11] See Basto and Oliveira (2001) and Cozian (2001).

[12] Case C-60/90 (Polysar Investments) and case C-333/91 (Satam SA).

[13] However, article 19 of the Sixth Directive allows the inclusion in the *pro rata* denominator of an operation outside the VAT scope: nontaxable subsidies that are not related to fixed assets.

[14] See Farmer and Lyal (1995); Palma (2004), and Cunha (2004).

[15] None of the Directive proposals to regulate the right of deduction across the EU has obtained agreement of the member states.

[16] Process C-177/99.

[17] See Farmer and Lyal (1995).

[18] As the companies involved are usually linked by personal and economic ties, one way that tax authorities in the EU have been uncovering this type of fraud is when in a competitive market – say, personal computer sales – an operator places a significant price discount. This can be an indication that the VAT received, and not paid by B, was used to undercut competition.

[19] This rule was changed, however, by transitional arrangements. Directive 91/680 created a different solution, which consists of considering the place of supply of transport services in intra-communitarian trade as the place of departure. However, if the acquirer is a VAT-registered person, a reverse charge mechanism applies, and the acquirer is responsible for the VAT.

[20] It must be said that these rules are far from being an exaustive characterization of location of services for VAT purposes in the EU. To give an example, in article 6 of the Portuguese VAT cod, where the service location rules are established, presently has 23 paragraphs, running for several pages.

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