

# Northwestern Journal of International Law & Business

---

Volume 22  
Issue 1 *Fall*


---

Fall 2001

## The Proposed E.U. VAT on Electronically Transmitted Services: Enforcement and Compliance Issues

Thomas Fawkes

Follow this and additional works at: <http://scholarlycommons.law.northwestern.edu/njilb>

 Part of the [Computer Law Commons](#), [International Law Commons](#), [International Trade Commons](#), [Internet Law Commons](#), [Taxation-Transnational Commons](#), and the [Tax Law Commons](#)

---

### Recommended Citation

Thomas Fawkes, The Proposed E.U. VAT on Electronically Transmitted Services: Enforcement and Compliance Issues, 22 Nw. J. Int'l L. & Bus. 47 (2001-2002)

This Comment is brought to you for free and open access by Northwestern University School of Law Scholarly Commons. It has been accepted for inclusion in Northwestern Journal of International Law & Business by an authorized administrator of Northwestern University School of Law Scholarly Commons.

# The Proposed E.U. VAT on Electronically Transmitted Services: Enforcement and Compliance Issues

*Thomas Fawkes\**

## I. INTRODUCTION

The growth of the Internet economy in the European Union (“E.U.”) has been nothing short of staggering. In the last three years, the amount of electronic commerce transactions in the E.U., including business-to-consumer (“B2C”), business-to-business (“B2B”), government and education transactions, has grown from under \$20 billion USD in 1997 to over \$200 billion USD in 2000.<sup>1</sup> Even this growth, however, pales in comparison to the expected growth over the next four years. By the year 2004, electronic commerce in the European Union is expected to grow tenfold, to over \$750 billion USD.<sup>2</sup> After including expenditures on website development and e-business infrastructure, the European Internet economy will eclipse \$1.3 trillion USD by 2004.<sup>3</sup>

With the booming Internet economy in Europe, foreign vendors, particularly those headquartered in the United States, will experience significant increases in sales revenues from European online customers, in both the consumer and business markets. Much of this revenue, particularly with respect to goods and services delivered through electronic transmission, has escaped the tax authorities of the E.U. member states, due to the current

---

\* J.D. Candidate, May 2002, Northwestern University School of Law, B.A., *summa cum laude*, Loyola University of Chicago, 1999. I wish to thank Lisa Blaesser for her comments on earlier drafts of this paper.

<sup>1</sup> John Gantz, et al., *Internet Business Strategies: Building Europe's New Economy*, THE STANDARD 1, (2000) at [http://www.thestandard.com/media/European\\_IDC.pdf](http://www.thestandard.com/media/European_IDC.pdf) (last visited Oct. 21, 2000).

<sup>2</sup> *Id.* at 2, fig. 2.

<sup>3</sup> *Id.*

structure of the value added tax ("VAT") regime.<sup>4</sup> The transactions that currently escape VAT are those involving the on-line supply of digital deliveries of goods and services, particularly those intended for final consumers, that are sold by non-E.U. based entities.<sup>5</sup> Under the current transitional system, E.U.-based vendors are subject to the VAT on all transactions, whether transmitted physically or electronically, leading to a competitive disadvantage relative to their non-E.U. (particularly American) competitors.<sup>6</sup>

The European Commission, in an effort to capture much of the untaxed revenue resulting from electronic commerce transactions and level the playing field between E.U. and non-E.U. electronic commerce vendors, recently proposed an amendment to the Sixth VAT Directive to address specifically VAT arrangements for electronic commerce.<sup>7</sup> Under this amendment, transactions involving the electronic delivery of goods and services would be taxed in a similar fashion to goods and services that are delivered by physical means. Hence, non-E.U. based vendors would be subject to a number of reporting, collection, and payment duties, as well as a system by which all foreign vendors would be required to register as a taxable person with an E.U. member state's tax authorities.<sup>8</sup>

While the proposed amendment to the VAT will bring consistency to the tax regime in the E.U., bringing taxation of e-commerce transactions on the same plane as taxation of tangible goods and services is objectionable for a number of reasons. Possibly the most compelling reason for opposing, at least for the time being, an amendment to the Sixth Directive allowing the imposition of VAT on non-E.U. electronic commerce vendors is the uncertainty, both legally and in practice, of an effective enforcement mechanism to ensure the complete and timely collection of VAT arising from electronic commerce transactions.

At least three major impediments exist to the effective administration and enforcement of a VAT requiring compliance by non-E.U. e-commerce vendors. First, no legal basis exists for bringing a non-E.U. based electronic vendor within the purview of the E.U. VAT scheme, in light of the long-standing requirement of fixed, or permanent, establishment. Second, the international nature of the proposed VAT regime will only further complicate the current E.U. enforcement scheme, which already suffers from a lack of trained personnel and the inability to effectively counter and prose-

---

<sup>4</sup> Jan L.N. Snel, *Taxation of Electronic Commerce: E-Commerce Developments & E.U. Vat* at 1 (pending publication), at <http://www.bmck.com/ecommerce/draftarticle.doc>.

<sup>5</sup> See Proposal for a Council Directive Amending Directive 77/388/EEC as regards the Value Added Tax Arrangements Applicable to Certain Services Supplied by Electronic Means, COM (2000) 349 final at 6 [hereinafter Explanatory Memorandum].

<sup>6</sup> David Hardesty, *Europe Proposes New Taxes on Non-E.U. Sellers*, E-COMMERCE TAX NEWS (June 18, 2000), at <http://ecommercetax.com/doc/061800.htm>.

<sup>7</sup> Explanatory Memorandum, *supra* note 5, at 3.

<sup>8</sup> *Id.* at 4, 8.

cute VAT fraud and evasion. Third, the opposition that has met the E.U. VAT proposals, particularly from the United States, may act to undermine the credibility of the VAT as a whole and may encourage non-compliance as a result. Because of these three potential pitfalls, this paper suggests that the E.U. may want to reconsider the integration of its VAT proposal until an international consensus can be formulated on how to reconcile the goals of the VAT with the unique nature of the Internet economy.

This paper will begin by discussing the current VAT system in the E.U. It will also describe in detail the provisions of the proposed VAT amendments as they affect electronic commerce transactions with respect to both B2B and B2C transactions. Next, the practical effects of the VAT amendments in terms of increased VAT revenue for the E.U. and its member states will be discussed. Following will be a discussion on the past and present failures of the E.U. and its Member States in encouraging and enforcing compliance under the current VAT Directive, and the implication of such failures on the proposed VAT amendments. This paper will conclude by discussing the inconsistencies between the proposed VAT amendments and the positions of international authorities, particularly the United States and the Organization for Economic Co-operation and Development ("OECD").

## II. THE CURRENT VAT SYSTEM IN THE EUROPEAN UNION

Under Article 99 of the Rome Treaty of 1957, there have been a series of "Directives," the goal of which has been to harmonize the various VAT collection schemes of the E.U. member states.<sup>9</sup> The current Directive governing harmonization of VAT is the Sixth Directive, passed in 1977.<sup>10</sup> While the Sixth Directive was intended to attain a complete harmonization of the member states' various VAT schemes, a number of loopholes in the Directive allowed member states to deviate significantly from the common scheme sought by the European Commission.<sup>11</sup> Under the Sixth Directive as originally formulated, the VAT was a destination consumption tax, meaning that exports were VAT-exempt, while imports were taxed at the border of the importing member state; thus the tax is levied at the member state of destination.<sup>12</sup>

In 1985, however, the Commission found that the fiscal borders system of the Sixth Directive was "incompatible with the single market concept" championed by the Commission.<sup>13</sup> Hence, the Sixth Directive was

---

<sup>9</sup> RICHARD DOERNBERG & LUC HINNEKENS, *ELECTRONIC COMMERCE AND INTERNATIONAL TAXATION* 25 (1999).

<sup>10</sup> *Id.* at 26.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 27.

<sup>13</sup> *Id.*

amended in 1993 to create the “transitional system.”<sup>14</sup> The transitional system was designed to allow a transition from having separate VAT schemes for each individual member state to having one common system amongst all member states.<sup>15</sup> Under the transitional system, member states maintain the destination system, but instead of collecting export VAT at a country’s borders, an administrative system at the consumptive level was established, with businesses responsible for identification, assessment, and payment of VAT.<sup>16</sup>

Under the transitional system, the VAT is an indirect consumption tax on the final price of supplies and goods sold in the European Union.<sup>17</sup> In contrast to an income tax, the VAT does not tax the activities of the producers of goods or the providers of services.<sup>18</sup> The producers of goods and providers of services collect the VAT on behalf of the member state in which they are domiciled.<sup>19</sup> With respect to production of tangible goods, the VAT is applied at each intermediate stage of production. This means that each “producer pays VAT on his own supplies (input VAT) and he charges VAT (output VAT) in respect of supplies to his clients who pay a price including VAT.”<sup>20</sup> The producer making a sale to a final consumer pays VAT only on the value added by his own labor and supplies.

#### A. The Transitional System Does Allow for the Taxation of Some Forms of Electronic Commerce

The method of collection under the transitional system is in large part dependent upon whether a transaction involves the delivery of a good or of a service. When, for example, a final consumer orders a tangible good (a DVD, CD, clothing, etc.) over the Internet, but the good is physically shipped to the consumer, this is considered “indirect electronic commerce,” and the rules governing the collection of VAT are identical to that of goods ordered by traditional means.<sup>21</sup>

When a good is shipped from one E.U. member state to another member state, the VAT is assessed and collected in the member state where the transport begins, unless the recipient of the good is a VAT-registered “taxable person,” in which case the recipient in his member state accounts for VAT.<sup>22</sup> When a good is imported to an E.U. member state from a non-E.U.

---

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> Hardesty, *supra* note 6, at 1.

<sup>18</sup> See European Union Law Reporter § 3102B (CCH 2001) [hereinafter Reporter].

<sup>19</sup> *Id.*

<sup>20</sup> *Id.* at § 3102C.

<sup>21</sup> DOERNBERG, *supra* note 9, at 245.

<sup>22</sup> Howard Lambert, *VAT and Electronic Commerce: European Union Insights Into the Challenges Ahead*, at <http://www.tax.org/ritp.nsf> (last visited Jan. 29, 2001).

vendor, such goods are subject to import VAT, which is collected when the goods enter an E.U. member state.<sup>23</sup> Because of the import VAT, “[n]on-E.U. sellers of goods are not required to register for and collect VAT.”<sup>24</sup> Therefore, goods ordered over the Internet, yet physically shipped to the E.U., remain subject to the import VAT, and thus sellers of tangible goods over the Internet will not be subject to administrative burdens as a result of the proposed VAT amendments.

### B. Direct Electronic Commerce

When a consumer purchases a good or service over the Internet and accepts electronic delivery of that good or service by downloading it onto his PC, this is characterized as “direct electronic commerce.”<sup>25</sup> This type of transaction illustrates where the goods versus services distinction becomes vital to the issue of how to administer VAT to electronic commerce transactions. If electronic downloads of goods and services were to be characterized as goods, they would be treated for VAT purposes in the same manner “as their physically delivered counterparts.”<sup>26</sup> However, since electronic deliveries do not go through the mails or customs, they would essentially avoid import VAT, much to the chagrin of the E.U. tax authorities.<sup>27</sup> Therefore, the European Commission has characterized all forms of direct electronic commerce as services rather than goods, which encompass a completely different collection scheme.<sup>28</sup>

At this point, the distinction between B2B and B2C transactions becomes more apparent. With respect to B2B transactions, under the transitional VAT arrangements in place since 1993, sales of goods by a VAT-registered trader in one E.U. Member State to a VAT-registered trader (typically a commercial entity) in another member state are exempt from VAT.<sup>29</sup> The VAT is payable in the destination member state by the recipient of the good. The burden of tax collection and payment in a B2B transaction flows from the producer to the purchaser so that tax revenue flows to the country of final consumption.<sup>30</sup> This shift in the tax burden is known as the “reverse charge mechanism.”<sup>31</sup>

Goods exported from an E.U. member state to a non-E.U. purchaser are taxed to the purchaser at a rate of 0%, and goods imported from a non-

---

<sup>23</sup> Hardesty, *supra* note 6, at 1.

<sup>24</sup> *Id.*

<sup>25</sup> DOERNBERG, *supra* note 9, at 245.

<sup>26</sup> Hardesty, *supra* note 6, at 1.

<sup>27</sup> *Id.*

<sup>28</sup> Explanatory Memorandum, *supra* note 5, at 4.

<sup>29</sup> See *VAT fraud: Commission calls on Member States to improve controls*, IP/00/115 at 1 (February 7, 2000) [hereinafter *VAT fraud*].

<sup>30</sup> *Id.*

<sup>31</sup> Explanatory Memorandum, *supra* note 5, at 6.

E.U. supplier are taxed at regular VAT rates on import.<sup>32</sup> In a B2B transaction involving a non-E.U. supplier and an E.U. purchaser, the reverse charge mechanism allows the supplier to escape collection and payment of VAT with the tax burden shifting to the E.U.-based purchaser. When the good is shipped, it is checked at the border to determine whether VAT has been paid; if not, the good is held at the border until the E.U.-based buyer comes forward to pay the tax.<sup>33</sup>

Under the proposed amendments to the Sixth Directive, B2B electronic commerce service transactions flowing from a non-E.U. vendor to a VAT-registered trader within the E.U. will continue to be subject to the reverse charge.<sup>34</sup> What this means is that in the typical B2B transaction involving a non-E.U. vendor and a VAT-registered E.U.-based recipient, the recipient will be responsible for self-assessment and payment of all VAT liabilities arising from the transaction.<sup>35</sup> Hence, non-E.U. based vendors engaging in electronic commerce transactions exclusively with VAT-registered traders in the E.U. will not be responsible for VAT assessment or payment, even under the proposed amendments to the Sixth Directive.<sup>36</sup>

### C. The Proposed Amendments to the Sixth Directive: B2C Transactions

The reverse charge mechanism, however, does not apply to B2C transactions. Where the recipient of a good or service is not a VAT-registered trader, the supplier of the good or service is responsible for adding VAT to the price of the good/service, as the final consumer is considered a “non-taxable” person.<sup>37</sup> The supplier is responsible for the collection and payment of the VAT to the tax authorities in the consumer’s member state of domicile.<sup>38</sup>

The VAT collection system becomes somewhat more complicated when non-E.U. parties are introduced into the system. When a non-E.U. seller provides a service to a “non-taxable” final consumer in the E.U. via electronic means, the non-E.U. seller is currently not required to collect and remit VAT.<sup>39</sup> The proposed amendments to Directive 77/388/EEC specifically address such transactions, under the rationale that there should be no difference in VAT treatment where a product can be delivered either physi-

---

<sup>32</sup> *Id.* at 3.

<sup>33</sup> Hardesty, *supra* note 6, at 1.

<sup>34</sup> Explanatory Memorandum, *supra* note 5, at 6.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 7.

<sup>38</sup> *See* Reporter, *supra* note 19, at § 3102B.

<sup>39</sup> Explanatory Memorandum, *supra* note 5, at 7. One exception to this rule is the telecommunications industry. Under current E.U. VAT policy, the general rule is that a non-E.U. seller of telecommunications services to an E.U. consumer is required to collect VAT. Such telecommunications services do not include electronically transmitted telecommunications services. *Id.*

cally or electronically. When certain products are delivered electronically, they do not go through the mails or through customs, thus leaving no practical way to collect VAT on import.<sup>40</sup>

Here lies the European Commission's primary motivation for amending the current VAT system. Currently, E.U.-based vendors of electronically delivered products *are* subject to VAT. Despite the intangible nature of the services they provide, the problems inherent in imposing VAT burdens on non-E.U. vendors, such as the lack of a practical method of VAT collection on import, do not similarly affect domestic vendors. Therefore, an E.U.-based vendor offering a similar service to a non-E.U. vendor is at a competitive disadvantage to his foreign counterpart.<sup>41</sup> Under the proposed VAT regime, the European Commission argues, this competitive disadvantage will be eliminated.<sup>42</sup> The European Commission has recognized that in light of the growth of the Internet economy, and the subsequent increase in the transfer of goods and services by electronic rather than physical means, the VAT regime requires updating to fully capture all Internet-based taxable revenue. In the words of the Commission:

The present system is poorly suited to the development of the most buoyant segment of the European and world economy, i.e., those international services which evade or increasingly might evade VAT on consumption within the Community. Current legislation is incapable of ensuring correct taxation in areas such as telecommunications, in which very rapid technological developments have occurred.<sup>43</sup>

### III. TRANSACTIONS THAT WILL BE AFFECTED BY THE PROPOSED VAT AMENDMENTS

Before continuing, it might be helpful to briefly describe what types of transactions will be affected by the proposed amendments to Directive 77/388/EEC. The new VAT regime will include as taxable transactions electronic deliveries of services for consideration. Therefore, the proposal will not affect services for which no charge is levied, such as free Internet access or free Internet downloads.<sup>44</sup> Aside from this exception, virtually all

---

<sup>40</sup> *Id.* at 2.

<sup>41</sup> Hardesty, *supra* note 6, at 3. Hardesty provides a useful example of the competitive disadvantage caused by the current VAT: "USeller is a U.S. retailer of entertainment software. The software is purchased online and downloaded from USeller's U.S. Web site. The company sells a certain software title for U.S.\$19.95. EuroSeller, a VAT-registered business in the E.U., also sells the same title for U.S.\$19.95. A buyer anywhere in the world will pay U.S.\$19.95 to purchase the software from USeller, but will pay up to U.S.\$24.94 (including VAT) when purchasing the title from EuroSeller. All other things being equal, the buyer will make the purchase from USeller." *Id.*

<sup>42</sup> At present, there is no empirical data suggesting that E.U. consumers engage in price shopping based on differentiations in VAT among vendors. *See id.* at 2.

<sup>43</sup> *A Common System of VAT. A program for the Single Market*, COM (96) 328 final at para. 1.2, 1.3.

<sup>44</sup> Explanatory Memorandum, *supra* note 5, at 12.



services delivered by electronic means will be taxable, including “all forms of broadcasting as well as other sound and images,” downloadable software applications (such as computer games), data processing, web-hosting, web-design, or the supplying of information in any form.<sup>45</sup> The term “by electronic means” does not, however, include the delivery of electronic content in tangible form (such as on compact discs (CDs) or digital video discs (DVDs)).<sup>46</sup>

Hence, the European Commission has devised a change to the transitional VAT arrangements that would impose a VAT burden on non-E.U. electronic commerce vendors for B2C transactions, similar to that of E.U.-based vendors. The proposal requires that all non-E.U. vendors in the business of supplying services through electronic means register with one E.U. Member State as a VAT-registered taxable person.<sup>47</sup> The registration procedure will be mandatory for only those vendors that sell directly to private consumers, and the “one state” requirements exists so that non-E.U. vendors can discharge all VAT obligations by dealing with a single tax administration.<sup>48</sup> After registering, the non-E.U. supplier will be responsible for self-assessment of VAT for each transaction undertaken with an E.U. private consumer, as well as payment to the tax collector of the member state in which the vendor is registered.<sup>49</sup> By instituting the “one state” registration requirement, the European Commission believes that E.U.-based and foreign vendors will be on a level playing field, as both will be subject to a similar collection burden when engaging in electronic commerce transactions with “non-taxable” persons in the E.U.<sup>50</sup>

The only exception to this rule is that a non-E.U. vendor need not register with a member state if its annual level of sales within the E.U. is below 100,000 Euro (approximately \$70,000 USD).<sup>51</sup> This exemption has been suggested in order to avoid placing undue burdens on the development of global e-commerce as a whole, as well as protecting those business only making occasional sales to European parties.<sup>52</sup> Due to this rather low threshold, only the smallest foreign vendors will be exempt from registration. All other non-E.U. vendors of electronically transmitted services will be expected to comply with the registration requirements.

In addition to the one state registration requirement, the European Commission has suggested a number of additional features designed to facilitate the collection and payment process for non-E.U. vendors. These

---

<sup>45</sup> *Id.* at 13.

<sup>46</sup> *Id.* at 14.

<sup>47</sup> *Id.* at 16.

<sup>48</sup> Explanatory Memorandum, *supra* note 5, at 4.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* at 7.

<sup>51</sup> *Id.* at 14.

<sup>52</sup> *Id.*

features include an fully automated, Internet-based solution for all procedures related to registration and the making of tax returns, as well as improvements to the VIES system to facilitate tax status verifications.<sup>53</sup> The European Commission believes that such improvements will serve to enhance compliance among non-E.U. vendors.<sup>54</sup>

The European Commission, in constructing a system of e-commerce taxation, has endorsed three main principles:

1. No new or additional taxes need to be considered, but existing taxes should be adapted to be applied to e-commerce;
2. For consumption taxes (such as the VAT), electronic deliveries should not be treated as goods, but as supplies of services;
3. Only supplies of such services consumed in the E.U. should be taxed in the E.U.; taxation should take place in the jurisdiction where consumption takes place.<sup>55</sup>

The Commission sought an amendment to the VAT that would not alter the fundamental law; it wishes to supplement the VAT law to meet present reality. By working within the framework of the existing law, the European Commission believes that the new VAT regime will be clear, consistent and simple, as well as neutral and non-discriminatory.<sup>56</sup>

#### IV. ENFORCEMENT AND COMPLIANCE OF THE PROPOSED VAT AMENDMENTS

The VAT has traditionally been considered “a tax whose effectiveness is based on self-assessment linked to a high level of voluntary compliance on the part of business.”<sup>57</sup> The E.U. has long placed responsibility on indi-

---

<sup>53</sup> Explanatory Memorandum, *supra* note 5, at 16. The VIES (VAT Information Exchange System) is a common computer network containing the VAT identification numbers of all VAT-registered entities in the European Union. Sellers use VIES to confirm the validity of a VAT identification number of a purchaser, which also allows the seller to determine whether or not reverse charge applies to a given transaction. *See* Third Article 14 Report on the Application of Council Regulation (EEC) No 218/92 of January 27, 1992 on Administrative Cooperation in the Field of Indirect Taxation (VAT) and Fourth Report Under Article 12 of Regulation (EEC, EURATOM) No 1553/89 on VAT Collection and Control Procedures, COM (2000) 28 final at 8 [hereinafter Third Article 14 Report].

<sup>54</sup> *Id.* at 9.

<sup>55</sup> Explanatory Memorandum, *supra* note 5, at 4.

<sup>56</sup> Jan L.N. Snel, *European Union Reaches Out Across Borders: European Union Proposes to Tax U.S.-Based E-Commerce Companies With Value Added Tax in the European Union 2*, at <http://www.bakerinfo.com/ecommerce> (last visited Sept. 17, 2000). With respect to neutrality, the European Taxation and Customs Union states that the proposed changes “ensure that traders do not face unfair competition simply because of the way in which customers communicate with suppliers or by which goods are sourced.” TAXATION AND CUSTOMS UNION; *see also* VAT on e-commerce – why the rules need to be changed, THE KEY 3 (Oct. 2000).

<sup>57</sup> Explanatory Memorandum, *supra* note 5, at 8.

vidual business operators as taxpayers to make its commercial presence known to tax authorities and to collect and remit VAT on their own volition.<sup>58</sup> Such a system, while reasonable among E.U. members, is likely to be ineffective in ensuring VAT compliance among Internet-based vendors, particularly those without a physical presence in an E.U. Member State.

Issues related to collection and enforcement in light of the proposed amendments to the Sixth VAT Directive far exceed those encountered in the traditional markets. Without physical delivery of goods across borders, the customs police of the respective E.U. member states no longer have a reliable method by which to prevent shipments of goods for which VAT has not been collected.<sup>59</sup> Second, given the fact that an overwhelming majority of non-E.U. vendors doing business over the internet in the E.U. do not have any sort of physical presence within an E.U. member state, threats of civil or criminal penalties for non-compliance of VAT collection and/or payment may ring hollow for many foreign vendors, causing them to willingly refuse to comply with the new VAT regime.<sup>60</sup> Third, E.U. member states may not be equipped with the technological tools necessary to enforce the new VAT policies through a digital medium.<sup>61</sup>

The most compelling argument, however, against a VAT imposed on non-E.U. electronic commerce vendors is the absence of a "fixed establishment" on E.U. soil – a requirement that pervades European VAT law.<sup>62</sup> The "fixed establishment" requirement, which essentially mandates that all entities subject to VAT in the E.U. have a fixed place of business within an E.U. member state or an agent physically located within the member state, may not be satisfied by the placement of a computer server on European soil – the only means by which a non-E.U. based electronic commerce vendor is present within a member state.<sup>63</sup> The proposition that a computer server does not constitute a "fixed establishment" has at least three areas of support: recent European Court of Justice ("ECJ") decisions, the electronic commerce working papers issued by the OECD, and the electronic commerce policies of the United States. Each of these areas of support will be discussed in detail.

#### A. The E.U. Philosophy: Voluntary Compliance

The European Commission fully believes that under its current policy of self-assessment and voluntary compliance, non-E.U. vendors under the

---

<sup>58</sup> Explanatory Memorandum, *supra* note 5, at 9.

<sup>59</sup> Howard Lambert, *VAT and Electronic Commerce: European Union Insights Into the Challenges Ahead*, 7, available at <http://www.tax.org/ritp.nsf> (last visited Jan. 29, 2001).

<sup>60</sup> *Id.* at 9.

<sup>61</sup> Interim Report on the implications of electronic commerce for VAT and customs, XXI/98/0359 at 17 [hereinafter Interim Report].

<sup>62</sup> DOERNBERG, *supra* note 9, at 255.

<sup>63</sup> *Id.* at 256.

proposed VAT regime will substantially comply with the new registration and collection requirements. The European Commission concedes that “the effectiveness of this approach to tax administrations can only be assured when it is underwritten by a reasonable and realistic expectation that non-compliance will be detected, remedied and that appropriate sanctions will be applied.”<sup>64</sup> The vendors’ reputations appear to be the VAT regime’s most effective deterrent to non-compliance by non-E.U. vendors. The Explanatory Memorandum says, “For an operator, even one located outside the E.U., to risk exposure to significant and unresolved tax debts in the world’s largest marketplace cannot be considered prudent business practice.”<sup>65</sup> Because a foreign vendor would not risk the damage to its reputation, not to mention its creditworthiness and liquidity, by failing to comply with the VAT, any reasonable business owner would make it a priority to fully comply. While a voluntary compliance system might be more efficient within the E.U., it does not solve the numerous enforcement-related issues associated with non-E.U. vendors. Considering the current inefficiencies associated with VAT monitoring and enforcement within the E.U., more may need to be done to ensure compliance in light of the proposed amendments to the Sixth Directive.

#### B. Current VAT Monitoring: Inefficient at Best

The E.U. and its respective member states have been at times unsuccessful in preventing VAT fraud and non-compliance, even among E.U.-based taxpayers. In a recent report on VAT collection and control procedures, the European Commission admits that to date, the VAT enforcement system has been inadequate to control tax scofflaws.<sup>66</sup> According to the report, the six years in which the transitional VAT arrangements have been in place “appear to have given the fraudsters time to appreciate the possibilities offered by the transitional VAT arrangements to make money, while, generally speaking, member states have not met the challenge posed by fraud.”<sup>67</sup> This failure by the E.U. to combat VAT fraud has led to a “gap” between actual collected VAT receipts and an estimate of the amount that should have been collected of 70 billion Euro, or approximately 21% of member states’ total VAT revenue.<sup>68</sup>

There are a number of reasons for this “gap” between expected and actual VAT revenues. The first, and probably the most significant, cause of VAT fraud is the high level of non-cooperation among tax administrations in both the member states individually and the central tax authorities. Since no integrated strategy exists among all E.U. member states as to VAT en-

---

<sup>64</sup> Explanatory Memorandum, *supra* note 5, at 9.

<sup>65</sup> *Id.*

<sup>66</sup> Third Article 14 Report, *supra* note 53, at 5.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.* at 13. These figures are for 1998. *Id.*

forcement and collection procedures, loopholes to the VAT laws are rampant, and information exchanges in response to possible fraud actions are often delayed or prohibited.<sup>69</sup> The operation of Article 5 of Regulation (EEC) No 218/92, as well as the VIES system, are illustrative of this point. Under Article 5, a member state can make specific requests for information from other member states "for the purpose or control of particular traders," related to invoice information, dates and values of individual transactions.<sup>70</sup>

While Article 5 was intended to allow tax authorities of the member states to engage in enforcement proceedings in the interim period between updates to the VIES, its actual practice has been proven ineffective.<sup>71</sup> First, tax authorities often fail to request information in accordance with Article 5, even when they have reason to believe that a particular trader may be engaging in fraudulent practices. In fact, over the period between 1996 and 1998, requests for administrative cooperation were made with respect to only 2% of traders making intra-community acquisitions.<sup>72</sup> Second, as a prerequisite to making an Article 5 request for information, a member state must first exhaust all other information-gathering possibilities, including Articles 4(2), 4(3), and the VIES system.<sup>73</sup>

Forcing a member state to exhaust its inferior resources can lead to costly delays in information gathering and subsequent enforcement actions against VAT scofflaws. Finally, information requests under Article 5 suffer from extensive delays and bureaucratic mismanagement. Currently, Regulation (EEC) No 218/92 mandates a three-month deadline for the satisfaction of all requests under Article 5.<sup>74</sup> Since 1996, there has been a 500% increase in the number of overdue replies under Article 5, with over 2500 overdue replies in the fourth quarter of 1998 alone.<sup>75</sup>

Many of the delays in making Article 5 replies are likely caused by a lack of personnel that are trained to administer VAT enforcement actions. On average, only about 8% of the Member States' tax administration staff are engaged in on-the-spot controls, which involve personal visits to VAT-registered traders to ensure compliance and investigate allegations of fraud.<sup>76</sup> Considering that there are currently 24 million VAT-registered traders in the E.U. alone, the Commission estimates that it would take ap-

---

<sup>69</sup> Third Article 14 Report, *supra* note 53, at 13.

<sup>70</sup> *Id.* at 21.

<sup>71</sup> *Id.*

<sup>72</sup> Third Article 14 Report, *supra* note 53, at 21.

<sup>73</sup> *Id.* at 22. Articles 4(2) and 4(3) allow a Member State to request more general information from another Member State with respect to information about whether one of its registered traders has made intra-Community transactions in a given quarter, as well as the identity of the suppliers from whom the purchases were made. *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *Id.* at 42.

<sup>76</sup> Third Article 14 Report, *supra* note 53, at 5.

proximately 40 years to complete on-the-spot controls of each trader.<sup>77</sup> It is clear that in light of the poorly executed exchange of information among member states, as well as the shortage of tax administration staff, taking on the additional responsibility of monitoring and enforcing the new VAT transactions under the proposed amendments to the Sixth Directive, without a significant improvement in monitoring protocol, will be a daunting task.

### C. Current VAT Enforcement: Similarly Inefficient

Given the difficulties of the E.U. and the individual member states in monitoring VAT transactions and in executing on-the-spot audits, it should come as no surprise that the E.U. has been similarly unsuccessful in enforcing the Sixth VAT directive with respect to non-compliance and fraud. This is in large part due to the minimal powers of member state tax authorities in pursuing tax scofflaws, as well as the numerous loopholes in the various tax laws, which permit fraudsters to evade prosecution. Under Article 2 of Regulation (EEC) No 218/92, all exchanged information pertaining to an alleged fraud or noncompliance action must go through the “competent authority” in a given Member State.<sup>78</sup> If the procedure in Article 2 is not followed, the information exchanged will not be considered valid, and cannot be used against the alleged fraudster.<sup>79</sup> Given the problems discussed above pertaining to information exchange, it is likely that a sizable number of potential fraudsters can escape liability through this procedural loophole. Another significant loophole authorized by Regulation (EEC) No 218/92 deals with the presence of foreign officials in another Member State for auditing purposes. Under current practice, the vast majority of Member States only permit the presence of foreign officials during controls *with the permission of the taxable person*.<sup>80</sup> This practice significantly limits the enforcement power of the Member States, in that a taxable person can simply refuse permission to a foreign VAT auditor where the purpose of the control is to investigate alleged fraud.

There are additional weaknesses in Community law that allows many frauds or non-compliances to escape unpunished. For instance, many member states have legislation in force that provides for a taxable person under investigation for fraud to be automatically notified if another member state makes a request for information on the taxable person.<sup>81</sup> This practice

---

<sup>77</sup> *Id.*

<sup>78</sup> Third Article 14 Report, *supra* note 53, at 28. A “competent authority” is an authority charged with tax administration in a given Member State. Competent authorities may include anti-fraud units, fiscal representatives of a Member State located in the embassies of other E.U. Member States, or Directorates of Taxation and Customs of the various Member States. *Id.* at 29.

<sup>79</sup> *Id.* at 28.

<sup>80</sup> *Id.* at 29.

<sup>81</sup> Third Article 14 Report, *supra* note 53, at 30.

is tacitly permitted under Directive 77/779/EEC, which is used as the legal basis for fraud cases in the E.U.<sup>82</sup> Furthermore, the current legal framework does not provide a legal base for exchanging information with non-E.U. countries.<sup>83</sup> Typically, this does not present much of a problem, as the customs authorities of the several member states can halt shipments of goods on import for failure to comply with VAT. When dealing with service transactions, however, this safeguard no longer exists.<sup>84</sup> Even when fraud is committed within the EU, under current law the fraud action cannot proceed where evidence is located in a non-E.U. country.<sup>85</sup>

#### V. ENCOURAGING COMPLIANCE IN THE NEW VAT REGIME: THE E.U. POSITION

Given the multitude of loopholes, inefficiencies, and lack of a solid base for the monitoring and enforcement of noncompliance of VAT laws, it is hard to imagine that this structure can be successful in monitoring and enforcing transactions involving electronic deliveries of services, a far more complex undertaking. In addition to the various shortcomings mentioned above, the introduction of a fully automated system for registration, reporting, and monitoring as envisioned by the Commission introduces a host of new challenges for E.U. tax administrators, none of which have been addressed to a satisfactory degree.<sup>86</sup>

Under the proposed amendments to the Sixth VAT Directive, the Commission plans on introducing a system whereby it will be possible to complete all registration procedures, tax returns, and taxable person identification functions over the Internet.<sup>87</sup> Furthermore, given the increasing use by businesses of computerized internal auditing procedures, the Commission intends on using VAT-registered taxpayers' sales data in order to increase its own auditing control efficiency.<sup>88</sup> While few would argue that such procedures will not lead to increased efficiency and lower compliance costs over time, the present reality is that the E.U. and the several member states are not prepared to implement such a system. The European Commission even admits that "European tax administrators ... have not been in the forefront in using electronics directly in dealing with their traders."<sup>89</sup> The Internet architecture necessary to allow electronic filing of all VAT-

---

<sup>82</sup> *Id.*

<sup>83</sup> *Id.* at 31.

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> See Explanatory Memorandum, *supra* note 5, at 4, 16.

<sup>87</sup> *Id.* at 16.

<sup>88</sup> Interim Report, *supra* note 61, at 19.

<sup>89</sup> *Id.* at 17.

related documents is not yet in place, and the European Commission has not offered a timeline for the completion of such architecture.

Furthermore, the existing structures of VAT collection are not equipped to handle the shift from paper-based to electronic accounting.<sup>90</sup> The European Commission estimates that only 3% of the E.U.'s VAT auditors are skilled in computer-based auditing, which may lead to additional enforcement headaches if the VAT proposals were to become effective.<sup>91</sup> In addition, the VIES currently does not allow for real-time transactions, which is essentially the cornerstone of e-commerce.<sup>92</sup> Until the VIES is updated to allow for real-time updates of taxpayer identification and location, and until it can be accessed via the Internet, the electronic simplifications promised by the Commission will be of little benefit to non-E.U. vendors taking part in the new VAT regime.

A further problem exists with respect to the identification of taxable/non-taxable persons under the proposed amendments. A non-E.U. vendor under the proposal will have no tax collection or payment responsibilities when the purchaser of an electronically transmitted service is a taxable person. However, the vendor must, with respect to each E.U. transaction, verify whether the purchaser is taxable.<sup>93</sup>

While the E.U. believes that automating the verification process will encourage compliance, many complications remain. First, for a medium-to-large business executing many transactions with E.U. residents, having to verify the taxable status of thousands of customers daily may be so costly and time-consuming as to discourage entry into the European market. Second, under Article 9(2)(e) of the 6th VAT Directive, taxable persons supplying services have *no legal obligation* to confirm that their customer within the E.U. has a valid VAT identification number.<sup>94</sup> This is a dangerous proposition, as it could have the unintended effect of placing a non-E.U. vendor in a position of inadvertent non-compliance, or alternatively, causing a non-E.U. vendor to pay VAT on more transactions than required under law, due to a lack of valid taxpayer identifications. This type of risk and uncertainty may act as a further disincentive to non-E.U. vendors transacting within the E.U.

## VI. THE "FIXED ESTABLISHMENT" REQUIREMENT

Virtually all modern tax treaties use the notion of fixed, or permanent, establishment as the main instrument to establish tax jurisdiction over a foreign person's business activities.<sup>95</sup> A foreign enterprise's business activities

---

<sup>90</sup> *Id.* at 20.

<sup>91</sup> Third Article 14 Report, *supra* note 53, at 19.

<sup>92</sup> Hardesty, *supra* note 6, at 4.

<sup>93</sup> Explanatory Memorandum, *supra* note 5, at 7.

<sup>94</sup> *Id.* at 17.

<sup>95</sup> ARVID A. SKAAR, PERMANENT ESTABLISHMENT 1 (1991) [hereinafter PERMANENT].



may be taxed by the country in which the activities are performed only if the enterprise has a permanent establishment there.<sup>96</sup> According to the OECD Model Tax Treaty, the term "permanent establishment" is defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried on."<sup>97</sup> The fundamental notion of permanent establishment "is that the foreign enterprise must have a certain *physical presence* abroad in order to get a [permanent establishment] there, such as a *fixed place of business, a building site, or an agent.*"<sup>98</sup>

The issue of permanent establishment is at the forefront of a determination of whether a taxation scheme that compels businesses in cyberspace to account and pay VAT to a foreign country's tax authorities. Typically, a business operating in cyberspace will execute transactions through the use of servers placed in various locations around the world.<sup>99</sup> These servers, however, need not be physically present in the country in which an electronic purchase is made.<sup>100</sup> For example, a customer in Germany may download a digital video disc from Amazon.com (an American company) through a server located in India.<sup>101</sup> Hence, electronic commerce poses a unique dilemma to the issue of permanent establishment, as a foreign electronic commerce vendor need not be physically present in an E.U. member state in order to do business there.

Professor Arvid Skaar presents a two part objective test to determine the physical presence of a taxpayer in a foreign country: (1) the place of business test and (2) the location test.<sup>102</sup> Under the place of business test, conventional wisdom dictates that only physical objects suited to serve as the basis for a business activity can be a place of business.<sup>103</sup> Hence, a web site cannot be a place of business, since it is merely a series of programmed code contained on a computer.<sup>104</sup> However, a server is a physical object, and thus the server itself, or the room or office in which it is contained, may constitute a physical presence sufficient to meet the place of business test.<sup>105</sup>

---

<sup>96</sup> PERMANENT, *supra* note 95, at 1.

<sup>97</sup> OECD Model Tax Convention (1977), art. 5(1). *See also* PERMANENT, *supra* note 95, at 1.

<sup>98</sup> Arvid A. Skaar, *Erosion of the Concept of Permanent Establishment*, in INTERNATIONAL STUDIES IN TAXATION: LAW AND ECONOMICS 309 (Gustaf Lindencrona, Sven-Olaf Lodin and Bertil Wiman eds., 1990)[hereinafter *Erosion*].

<sup>99</sup> Clayton W. Chan, *Taxation of Global E-Commerce on the Internet: The Underlying Issues and Proposed Plans*, 9 MINN. J. GLOBAL TRADE 233, 252 (Winter 2000).

<sup>100</sup> *Id.* at 252.

<sup>101</sup> Chan, *supra* note 99, at 252.

<sup>102</sup> *Erosion*, *supra* note 98, at 309.

<sup>103</sup> *Id.*

<sup>104</sup> *Id.*

<sup>105</sup> *Id.* at 310.

The location test, on the other hand, may be far more difficult to satisfy. Under the location test, the place of business must be linked to a specific geographical point in the source state.<sup>106</sup> While the location of a server in an office will normally meet the requirements of the location test, one can imagine a situation, based on the above example, where a server is not located in the same state in which a transaction is being made.<sup>107</sup> In this case, the location test does not offer an accurate determination of whether a server constitutes a permanent establishment.

Aside from the above objective tests, a permanent establishment may exist even if the server itself is not considered a permanent establishment. Alternatively, some have argued that a server acts as an agent that constitutes an agency permanent establishment.<sup>108</sup> According to the definition of agent in the OECD Model Tax Convention, an agent has to be a “person,” and a “person” is defined in Article 3(1)(a) as “an individual, a company and any other body of persons.”<sup>109</sup> From this definition, it is clear that a server, as well as a web site, cannot be considered an agent, since a machine does not satisfy the “person” requirement of an agency permanent establishment.<sup>110</sup> Hence, an argument that an agency permanent establishment is created by the presence of a server holds little weight.

The European Commission has attempted to create a permanent establishment for non-E.U. based vendors via the one state registration requirement. Proposed Article 9(2)(f) of Directive 77/388/EEC reads:

For such services, however, when they are supplied by a taxable person identified in accordance with the provisions in force to non-taxable persons established in the Community, the place of supply shall be the place where the supplier has established his business or has a fixed establishment from which the service is supplied. For the purposes of point f, a taxable person established outside the Community shall be deemed to have a fixed establishment in the Member State of identification for services covered by this provision and supplied under that identification.<sup>111</sup>

Based on this provision, the European Commission intends to create a permanent establishment based on the non-E.U. based vendor’s member state of identification, despite the possible absence of any physical presence in that member state. In fact, other than the one state registration requirement, there is no language in the proposed VAT amendments mandating that a server or any other physical property belonging to the non-E.U. based vendor actually be present in the state of identification.<sup>112</sup>

---

<sup>106</sup> *Id.*

<sup>107</sup> *Id.* See also Chan, *supra* note 99, at 252.

<sup>108</sup> *Erosion*, *supra* note 98, at 316.

<sup>109</sup> *Id.* See also OECD Model Tax Convention (1977), art. 3(1)(a).

<sup>110</sup> *Erosion*, *supra* note 98, at 317.

<sup>111</sup> Explanatory Memorandum, *supra* note 5, at 24.

<sup>112</sup> *Id.*

This lack of a physical presence may be a serious impediment to the success of the proposed VAT amendments, given the rather narrow construction of the term "fixed establishment" by the European Court of Justice, as well as individual E.U. member state courts.<sup>113</sup> In *Customs and Excise Commissioners v. Chinese Channel Ltd.*, an English court held that a Hong Kong broadcasting company which made all key corporate decisions in Hong Kong did not have a fixed establishment in the United Kingdom, despite the company's supply of broadcast television to British residents.<sup>114</sup> The court found that under Article 9(2)(c) of the Sixth VAT Directive, a subsidiary based in the U.K., which received taped television programs from Chinese Channel and arranged to uplink those programs to broadcast satellites, was a separate legal entity from Chinese Channel and did not constitute the requisite physical presence to be considered a permanent establishment in the U.K.<sup>115</sup>

The court in *Chinese Channel* followed the decision of the European Court of Justice in *Berkholz*, a seminal decision on permanent establishment related to VAT.<sup>116</sup> In *Berkholz*, a German company installed and operated gambling machines on two ferry boats which operated between Germany and Denmark.<sup>117</sup> Aside from the machines themselves, *Berkholz* did not maintain a permanent staff on the ferryboats.<sup>118</sup> Although it was estimated that 75% of the revenues earned on the machines were generated while in Denmark, the German tax authorities claimed that it was entitled to VAT on all revenues, regardless of where they were earned, since the machines constituted a permanent establishment in Germany.<sup>119</sup> The court held, however, that the gaming machines did not constitute a permanent establishment, since the machines did not constitute a permanent presence of "both the human and technical resources" as required in the Sixth Directive.<sup>120</sup>

A more recent ECJ decision along the lines of *Berkholz* is *ARO Lease BV*, which involved a leasing company based in the Netherlands supplying passenger cars to customers located in Belgium.<sup>121</sup> The leasing company, which did not have an office in Belgium, drew up the leasing contracts from its home office in the Netherlands and delivered the cars to its customers in

---

<sup>113</sup> Lambert, *supra* note 59, at 6.

<sup>114</sup> *Customs and Excise Commissioners v. Chinese Channel Ltd.*, 1998 S.T.C. 347 (1998).

<sup>115</sup> *Id.*

<sup>116</sup> *Id.* at 353.

<sup>117</sup> Case 168/84, *Berkholz v. Finanzamt Hamburg-Mitte-Alstadt*, 1985 ECJ CELEX LEXIS 3261, at \*6 (July 4, 1985).

<sup>118</sup> *Id.*

<sup>119</sup> *Berkholz*, 1985 ECJ CELEX LEXIS 3261 at \*7.

<sup>120</sup> *Id.* at \*19.

<sup>121</sup> Case 190/95, *ARO Lease BV v. Inspecteur van de Belastingdienst Grote Ondernemingen te Amsterdam*, 1997 ECJ CELEX LEXIS 7523, at \*5, \*6 (July 17, 1997).

Belgium through Belgian car dealers, who were not involved in the performance of the agreements.<sup>122</sup> The court held that Belgian tax authorities were not entitled to VAT from the lease agreements signed with Belgian consumers.<sup>123</sup> The fact that customers selected their vehicles from Belgian dealers, the court opined, had no bearing on the place of establishment of the supplier of services, which was clearly the Netherlands.<sup>124</sup> Since the leasing company did not have an office or human personnel in Belgium, the court found that the company did not have a fixed establishment in Belgium.<sup>125</sup>

While the above cases do not address specifically the issue of electronic commerce, they do indicate the position of the E.U. courts on permanent establishment. The narrow construction adopted over the last fifteen years by the courts may lead to the conclusion that the mere registration of a non-E.U. vendor in an E.U. member state will be insufficient to establish permanent establishment.<sup>126</sup> Since there are not any cases on the subject of electronic commerce at this point, it remains to be seen whether the E.U. courts will be receptive to the amendments to the Sixth Directive.

#### A. The OECD and United States Response: A Narrow Interpretation of Permanent Establishment

Both the OECD and the United States have recently come out in favor of a narrow interpretation of permanent establishment, similar to that espoused by the E.U. courts in *Chinese Channel*, *ARO Lease BV*, and *Berkholz*. Recently, the OECD issued its findings on permanent establishment as it relates to electronic commerce taxation.<sup>127</sup> The consensus of the Committee on Fiscal Affairs is that:

A web site cannot, in itself, constitute a permanent establishment, that a web site hosting arrangement typically does not result in a permanent establishment for the enterprise that carries on business through that web site and that an ISP [Internet Service Provider] will not, except in very unusual circumstances, constitute a dependent agent of another enterprise so as to constitute a permanent establishment of that enterprise.<sup>128</sup>

The OECD does not, however, state the opinion that in no circumstances can a server constitute a permanent establishment.<sup>129</sup> If, for exam-

---

<sup>122</sup> *Id.* at \*7.

<sup>123</sup> *Id.* at \*15.

<sup>124</sup> *ARO Lease BV*, 1997 ECJ CELEX LEXIS 7523 at \*14.

<sup>125</sup> *Id.* at \*15.

<sup>126</sup> Lambert, *supra* note 59, at 6.

<sup>127</sup> OECD, "Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on Article 5" (December 22, 2000) [hereinafter Commentary].

<sup>128</sup> *Id.* at 2.

<sup>129</sup> *Id.* at 3.

ple, a non-E.U. vendor were to operate a server in an E.U. member state without an intermediary (such as an ISP), and had the server at its own disposal, the place where the server is located could constitute a permanent establishment.<sup>130</sup> Despite this statement, at least one E.U. member state, the United Kingdom, has taken the view that “in no circumstances do servers, of themselves or together with web sites, constitute permanent establishments of e-tailers.”<sup>131</sup>

The United States has adopted a similar view of permanent establishment in its policy document on taxation of electronic commerce.<sup>132</sup> Examining the issue from the viewpoint of foreign electronic commerce businesses in the United States, the Treasury Department states: “to the extent that the activities of a person engaged in electronic commerce are equivalent to the mere solicitation of orders from U.S. customers, without any other U.S. activity, it may not be appropriate to treat such activities as a U.S. trade or business.”<sup>133</sup>

Furthermore, the Treasury Department takes the position that “a server, or similar equipment, is not a sufficiently significant element in the creation of certain types of income to be taken into account for purposes of determining whether a U.S. trade or business exists.”<sup>134</sup> The Treasury Department essentially compares a computer server to an electronic warehouse, and since Article 5 of the OECD Model Tax Convention states that a permanent establishment generally does not include facilities solely for the purpose of storage, display, or delivery of goods or merchandise, a computer server cannot likely be considered a permanent establishment.<sup>135</sup> In addition, the Treasury Department argues that the use of an ISP would not constitute an agency permanent establishment, but would likely be considered an independent agent relationship, “with the result that ... a permanent establishment would not arise.”<sup>136</sup>

The policies of the United States and the OECD suggest that the European Union’s justification for the proposed VAT amendments may not be compatible with the notion of permanent establishment. Without a physical presence in the E.U. member state of registration, aside from computer server equipment, imposing VAT upon a non-E.U. vendor appears to run counter to prevailing American and international positions on the importance of permanent establishment as a basic tenet of consumption tax law. It remains to be seen, however, if the European Union can reconcile tradi-

---

<sup>130</sup> Commentary, *supra* note 127, at 4.

<sup>131</sup> *Id.* at 3.

<sup>132</sup> *Selected Tax Policy Implications of Global Electronic Commerce*. Department of the Treasury, Office of Tax Policy (November 1996) [hereinafter Treasury].

<sup>133</sup> *Id.* at 25.

<sup>134</sup> *Id.*

<sup>135</sup> Treasury, *supra* note 132, at 26.

<sup>136</sup> *Id.* at 27.

tional notions of permanent establishment with the proposed VAT amendments.

## VII. POSSIBLE SOLUTIONS TO THE VAT DILEMMA

In light of the controversy that has surrounded the proposed VAT amendments, a number of alternates to the VAT scheme as proposed have been suggested.

One alternate suggestion is to impose a 0% VAT rate on all transactions, both intra- and extra-Community, on transactions of electronically transmitted services.<sup>137</sup> A 0% VAT, while having the obvious effect of diverting potential VAT revenues from member states' coffers, will serve to equalize the positions of E.U. based and non-E.U. based electronic service providers. Since the potential for tax revenues from electronically transmitted service transactions remains relatively insignificant, the overall effect on member states' treasuries will be minimal.<sup>138</sup> Furthermore, the potential headaches that could arise in terms of compliance and enforcement would be absent in such a scheme.

A second suggestion is to transfer responsibility for VAT collection and payment in electronically transmitted service transactions to the final consumers themselves.<sup>139</sup> The main benefit of such a system is that taxation would occur in the place of consumption, a goal sought after by both the E.U. and the OECD.<sup>140</sup> A drawback to such a program, however, is that compliance and enforcement efforts may be even more strained than under the E.U.'s proposal. Under this suggestion, each individual consumer downloading services from a non-E.U. vendor would be required to individually account for and pay VAT on each transaction, which would clearly be untenable, given the current inability of E.U. tax authorities to monitor transactions.

A third option is to look to Article 9.2(e) of the Sixth Directive, which moves the place of sale for intangible services to the country of the customer.<sup>141</sup> While this section would allow the E.U. to tax non-E.U. based vendors in the recipient's home country, it would create a number of additional problems. One is that Article 9.2(e) assumes that customers have a fixed establishment to which a service has been supplied, or a permanent address or a usual place of residence.<sup>142</sup> The difficulty with applying Article 9.2(e) to electronic commerce is that it is often difficult to determine the location of a customer over the Internet, and often the customer's billing address may not match the location where the services have been sup-

---

<sup>137</sup> Snel, *supra* note 4, at 6.

<sup>138</sup> *Id.*

<sup>139</sup> *Id.* at 4.

<sup>140</sup> See Explanatory Memorandum, *supra* note 5, at 4.

<sup>141</sup> Lambert, *supra* note 22, at 6.

<sup>142</sup> *Id.* at 7.

plied.<sup>143</sup> This may create an administrative nightmare for E.U. VAT authorities, who would be forced to somehow track each individual transaction over the Internet to determine the proper tax country.

#### VIII. CONCLUSION

The best solution, however, would be to put any amendments to the VAT on hold, at least for the time being. It appears that forcing non-E.U. suppliers of electronically transmitted services to act as tax collectors for the E.U. member states is premature for a number of reasons. First, the enforcement regime of the E.U. suffers from a lack of internal efficiency, which would only get worst once the international community is brought within the realm of taxpayers. Second, a number of European Union regulations dealing with enforcement need revision in order to be effective in the enforcement of non-E.U. based vendors. And most important, E.U. authorities must find a way to rectify its desire for additional tax revenue with the narrow interpretation attached to permanent establishment by the E.U. courts, the OECD, and the United States.

Nevertheless, the most compelling reason to delay the imposition of a VAT on electronically transmitted service transaction is the potential effect it may have on electronic commerce in the E.U. The prevailing opinion among the e-business community, particularly in the United States, is that of vehement opposition.<sup>144</sup> Requiring non-E.U. vendors, particularly those operating in the United States, to act as E.U. tax collectors could induce such a strong disincentive to doing business with Europe that instead of risking the costs and liability risks, may opt to remain out of the European market. If this were to occur, the ultimate losers with respect to the VAT would be European businesses and consumers, who would be deprived of a number of options with respect to electronic service choices. Given the European Union's current position as second fiddle to the United States in the e-commerce realm, it cannot afford to alienate its single most valuable asset in the Internet revolution. For these reasons, the most prudent option is to allow the Internet economy to grow unencumbered, at least for the time being.

---

<sup>143</sup> *Id.*

<sup>144</sup> Paul A. Greenberg & Lori Enos, *U.S. Seeks E.U. Internet Tax Accord*, E-COMMERCE TIMES, at <http://www.ecommercetimes.com/news/articles2000/000720-6.shtml> (July 20, 2000). According to Ken Wasch, president of the Software & Information Industry Association, "U.S. vendors should not be tax collectors for European governments. It is also doubtful, under public international law, whether the E.U. has any authority to impose such a legal obligation on U.S. entities." *Id.*