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Taxation of virtual currency

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7 | Indirect tax: general considerations

7.1 INTRODUCTORY REMARKS

Chapters Seven to Nine are concerned with indirect tax aspects of virtual currency. They answer the following research questions:

- 1) How transactions involving virtual currencies and items should be taxed (the model scenario)?
- 2) How transactions involving virtual currencies and items are actually taxed under the existing tax legislation (the actual scenario)?
- 3) How the actual scenario can be aligned with the model scenario?

The answer to the first question is provided in Chapter Seven, where the characteristics of a model system for taxing transactions involving virtual currencies and items are described (*see* section 7.5.). The model system is based on the general principles of taxation: neutrality, equity, certainty and administrative feasibility. Chapter Seven also provides some information on the general characteristics of indirect taxes (*see* section 7.2.), their history (*see* section 7.3.) and the development of electronic commerce since this commercial channel is relevant for phenomena (such as virtual currency) that exist only in digital form and are transmitted via electronic networks (*see* section 7.4.).

The answer to the second question is provided in Chapter Eight. Chapter Eight compares the tax treatment of virtual transactions in two indirect tax systems: EU VAT (*see* section 8.1.) and US retail sales tax (*see* section 8.2.), since the European Union and the United States remain two of the world's most important consumer markets, with a combined population of more than 800 million people.

EU VAT is explained on the basis of the EU VAT legislation and follows the structure of the VAT Directive,⁷⁶¹ making references to the national rules if necessary. As regards the United States, since there is no federal sales tax, the features common to the majority of states are discussed. Although Chapter Eight deals exclusively with the European Union and the United States, the issues that arise there and the different approaches taken by these jurisdictions

⁷⁶¹ Council Directive 2006/112/EC of 28 November 2006 on the Common System of Value Added Tax, OJ L 347 of 11 Dec. 2006 (hereinafter: the „VAT Directive“).

Table 5: Thesis structure

	<i>Income tax</i>	<i>Indirect tax</i>
<i>Model scenario</i>	<p>Chapter 4</p> <ul style="list-style-type: none"> - Answers the question: how income from virtual trade should be taxed - Describes the model income tax system that meets the criteria of equity, neutrality, certainty and administrative feasibility - Is independent of country-specific characteristics 	<p>Chapter 7</p> <ul style="list-style-type: none"> - Answers the question: how transactions involving virtual currencies and items should be taxed - Describes the model indirect tax system that meets the criteria of equity, neutrality, certainty and administrative feasibility - Is independent of country-specific characteristics
<i>Actual scenario</i>	<p>Chapter 5</p> <ul style="list-style-type: none"> - Answers the question: how income from virtual trade is actually taxed under the existing tax legislation - Describes the income tax systems of the United States, United Kingdom, Germany and the Netherlands - Each country-specific chapter is organized according to the income categories (e.g. business income, miscellaneous income, capital gains) - Does not provide recommendations or suggestions for improvement 	<p>Chapter 8</p> <ul style="list-style-type: none"> - Answers the question: how transactions involving virtual currencies and items are actually taxed under the existing tax legislation - Describes the indirect tax systems of the European Union and the United States - Each country-specific chapter is organized according to the structural elements of the indirect tax system (e.g. personal scope, taxable transactions, exemptions) - Does not provide recommendations or suggestions for improvement
<i>Comparison</i>	<p>Chapter 6</p> <ul style="list-style-type: none"> - Answers the question: how the actual scenario can be aligned with the model scenario - Compares the actual scenario with the model one and makes recommendations for improvement of the existing tax systems 	<p>Chapter 9</p> <ul style="list-style-type: none"> - Answers the question: how the actual scenario can be aligned with the model scenario - Compares the actual scenario with the model one and makes recommendations for improvement of the existing tax systems

may have implications for a wide range of countries around the world that have modeled their indirect tax systems after the US or the European one and are also trying to find the best way to tax cross-border consumption in the Information Age. Chapter Eight also takes a closer look at the issues surrounding cross-border transactions that take place between individuals from the European Union and the United States (*see* section 8.3.). It investigates whether the lack of international coordination could cause double taxation or unintentional non-taxation of virtual transactions, both of which could affect competition and lead to market distortions.

Chapter Nine compares the actual scenario described in Chapter Eight with the model system for taxing virtual transactions presented in Chapter Seven. It identifies the features of the existing tax systems that deviate from those of the model system (*see* section 9.2. for EU VAT and 9.3. for US sales tax) and makes recommendations for their improvement.

The structure of the indirect tax chapters, as well as their parallelism to the income tax chapters, is shown in Table 5 (which reproduces Table 1 from section 1.3.).

The chapters on income tax have identified three types of activity involving virtual currencies that are relevant for income tax purposes:

- creation of virtual currency (through mining or completion of quests);
- possession of virtual currency that appreciates in value;
- exchanges of virtual currency into traditional currency or other assets.

Given the fact that indirect taxes are levied on transactions, only events involving transfers or dealings with other parties are relevant for indirect tax purposes. These include exchanges of virtual currency and its creation through mining or completion of quests.

7.2 GENERAL CHARACTERISTICS AND TYPES OF INDIRECT TAXES

The objective of indirect consumption tax is to tax expenditures made by persons for their private purposes. It is the final consumer who should bear the tax burden. However, the tax is levied on transactions and remitted by a person different than the final consumer. Indirect consumption taxes vary in coverage, systematic approach and name. Some are of general nature, whereas others are levied only on certain products (for example, alcohol, tobacco and petroleum). The latter are not discussed in this thesis due to their irrelevance for virtual currencies.

Indirect taxes are an increasingly important revenue source. In the OECD member countries, the share of taxes on general consumption as a percentage of the GDP rose from 3.3% in 1965 to 6.7% in 2009. In 2009, the consumption tax revenue comprised about 20% of the total tax revenue, with VAT accounting

for the largest part (6.4%).⁷⁶² In the United States, retail state taxes yield almost a third of the state tax revenue.⁷⁶³ In the European Union, VAT receipts accounted for 22% of the national tax revenues of Member States (including social security contributions) in 2012.⁷⁶⁴

Indirect taxes can be imposed at all stages of the manufacturing and distribution chain or only at one stage. An all-stage tax may be either cumulative or non-cumulative. Tax accumulation occurs when an amount of tax paid at a previous stage is again subject to tax at a later stage and, as a result, the same amount is subject to multiple taxation, the magnitude of which is determined by the length of the transaction chain: the longer the chain, the higher the tax. As there is no deduction for tax incurred on purchases, the tax cascading effect favours integrated businesses and leads to distortion of competition. The most frequently applied form of cumulative tax is gross receipt tax (GRT).⁷⁶⁵

In contrast, a non-cumulative tax takes into account the tax paid at an earlier stage, i.e. it applies only to the value added by the business. Three distinct approaches are available to determine the added value.⁷⁶⁶ The first one (subtraction method) relies on aggregative data over a fixed period and taxes the difference between the total sales and purchases. Under the second one (addition method), all elements of the turnover (wages, interest, royalties, profit and subsidies) are taxed, provided that they have not been taxed at previous stages of the distribution chain. Both methods cannot accommodate multiple rates and exemptions because they do not distinguish different product categories within the sales. The third method (invoice credit method) calculates the tax on a transaction-by-transaction basis. Tax liability is determined by subtracting tax paid on the purchases (input) from tax due on the sales (output). This method is most frequently used to assess consumption tax. The most widespread non-cumulative tax is the value added tax (VAT), also called goods and services tax (GST). Limited to fewer than ten countries in the late 1960s, it has now been implemented by over 150 jurisdictions, where it often accounts for a large part of the total tax revenue.⁷⁶⁷

Single-stage taxes are classified according to the stage of the production and distribution chain at which the tax is applied: such tax can take the form of a manufacturer tax, a wholesaler tax or a retailer tax.⁷⁶⁸ The main ad-

762 OECD, *Consumption Tax Trends*, ch. 3 (2012).

763 US Census Bureau, *State Government Tax Collections Summary Report: 2011* (12 Apr. 2012), available at: <http://www2.census.gov/govs/statetax/2011stcreport.pdf>.

764 Eurostat, *Taxation Trends in the European Union*, Annex A, Table 7 (2013).

765 R.F. van Brederode, *Systems of General Sales Taxation*, ch. 3.2. (Wolters Kluwer 2009).

766 For a detailed description of those methods, see *id.*, at ch. 3.2.2; and B. Terra & J. Kajus, *Introduction to European VAT (Recast)*, sec. 7.5.3. (2012), Online Books IBFD.

767 OECD, *Consumption Tax Trends*, ch. 1 (2012).

768 Brederode, *Systems of General Sales Taxation*, *supra* n. 765, at ch. 3.1; Terra & Kajus, *Introduction to European VAT (Recast)*, *supra* n. 766, at sec. 7.4.1.

vantage of the first two types is that there is a relatively low number of taxpayers. However, as the basis of the tax is not the retail price, identical goods are not taxed equally when sold to final consumers. The degree of business integration influences the effective tax rate borne by the final consumer, and this may lead to distortions of competition. If a production process includes several manufacturers, tax accumulation occurs and creates an incentive to vertical integration. A drawback of a wholesale tax is complexity that arises when services are integrated in the system: although services should be exempt at the wholesale stage, unless they are rendered to final consumers, it is difficult for a supplier to determine in what capacity a buyer is purchasing a service.

A retail sales tax (RST) is applied to all supplies to final consumers, including those made by manufacturers and wholesalers.⁷⁶⁹ The basis of taxation is the retail price. RST does not discriminate against some forms of distribution channels and has the advantage of simplicity. However, it makes it necessary to distinguish between taxable business-to-consumer (B2C) and exempt business-to-business (B2B) transactions, which may be problematic especially in the case of services. In many situations, the service provider has no means to verify for what purpose a transaction is carried out. Although the application of retail sales taxes is retreating because of the growing popularity of VAT, they still remain persistent in the United States.

Although an ideal RST and an ideal VAT should be economically equivalent, the differences between those two types of taxes, especially the collection mechanism, may affect their economic impact and administrative efficiency. Proponents of VAT argue that it is more resistant to losses because of the incremental collection method. On the other hand, a VAT system which offers input tax deductions all the way up an economic chain may actually be more susceptible to fraud.⁷⁷⁰

7.3 HISTORY OF INDIRECT CONSUMPTION TAXES

The rise to prominence of indirect consumption taxation occurred in the twentieth century. Gross receipt and sales taxes became a popular instrument to pay for the World War II expenses and to compensate for reduced revenues from other taxes after the Great Depression in Europe and in the United States. Although US sales taxes were introduced as temporary measures, they have been maintained to date as a reliable revenue source.⁷⁷¹

⁷⁶⁹ Brederode, *Systems of General Sales Taxation*, *supra* n. 765, at ch. 3.1.3.

⁷⁷⁰ R. de la Feria & R. Krever, *Ending VAT Exemptions: Towards a Post-Modern VAT*, sec. 1.02, in: *VAT Exemptions* (R. de la Feria ed., Wolters Kluwer 2013).

⁷⁷¹ R.F. van Brederode, *Introduction to the US State Sales and Use Taxes*, 18 Intl. VAT Mon. 4, sec. 1 (2007).

The theoretical origins of VAT are attributed to Thomas S. Adams and Wilhelm von Siemens. German Industrialist Wilhelm von Siemens proposed the tax under the name “ennobled turnover tax” (*veredelte Umsatzsteuer*) in 1919.⁷⁷² American economist Thomas S. Adams suggested VAT in the form of a business tax as a replacement for US corporate income tax in 1921.⁷⁷³ Initially, the suggestions of both writers yielded little influence. In Europe, France was the first country to adopt VAT in 1954 by gradually modifying its gross receipt tax.⁷⁷⁴ The spread of VAT can be credited to the European integration process, which required the establishment of a common market and the harmonization of indirect taxation.⁷⁷⁵ At the time the European Economic Community (EEC) was created, all of the six original Member States (except France) levied gross receipts taxes. Shortly after the creation of the EEC, a commission headed by Professor Fritz Neumark was established and charged with determining “whether and to what extent the present differences between the financial systems of the Member States impede, or even render impossible, the establishment of a common market”, and “what possibilities exist to eliminate those differences”.⁷⁷⁶ The Neumark Commission investigated both RST and VAT, and rejected the former in favour of the latter. The RST was not considered a suitable alternative on the practical grounds, especially due to the large number of small retailers, most of whom were thought to be unable to keep adequate books.

In the First VAT Directive of 11 April 1967,⁷⁷⁷ the ECC declared that all Member States should adopt VAT. The Second VAT Directive of the same date⁷⁷⁸ set out the common VAT system. However, the VAT system based on those Directives permitted Member States such discretion that in practice nine different and separate national systems existed. The Directives prescribed only the general features and left it to the Member States to determine the VAT coverage and the rate structure. On 17 May 1997, the Sixth Directive⁷⁷⁹ was enacted with the aim to harmonize various national laws. As this new VAT

772 C. von Siemens, *Veredelte Umsatzsteuer* (Siemensstadt 1919), who cites his brother Wilhelm von Siemens as originator of the proposal.

773 T.S. Adams, *Fundamental Problems of Federal Income Taxation*, 35 *Quarterly Journal of Economics*, pp. 527-556 (1921).

774 Brederode, *Systems of General Sales Taxation*, *supra* n. 765, at ch. 2.

775 For the history of harmonization of indirect taxation in the European Union, see B.J.M. Terra & P.J. Wattel, *European Tax Law*, 6th ed., sec. 4 (Kluwer Law International 2012).

776 Report of the Financial and Fiscal Committee (1963) (the “Neumark Report”).

777 *First Council Directive 67/227/EEC of 11 April 1967 on the Harmonization of Legislation of Member States Concerning Turnover Taxes*, OJ 71 of 14 Apr. 1967.

778 *Second Council Directive 67/228/EEC of 11 April 1967 on the Harmonisation of Legislation of Member States Concerning Turnover Taxes – Structure and Procedures for Application of the Common System of Value Added Tax*, OJ 71 of 14 Apr. 1967.

779 *Sixth Council Directive 77/388/EEC of 17 May 1977 on the Harmonization of the Laws of the Member States Relating to Turnover Taxes – Common System of Value Added Tax: Uniform Basis of Assessment*, OJ L145 of 13 June 1977 (hereinafter: the „Sixth Directive“).

legislation became part of the *acquis communautaire*, the introduction of a VAT system became pre-condition for accession of any countries subsequently joining the ECC and its successors (the European Community and the European Union). After its implementation, the Sixth Directive underwent many changes, and those amendments were often contained in separate documents. In order to improve the quality of the EU VAT rules and bring together various provisions into one piece of legislation, the VAT Directive (recasting the Sixth Directive) was adopted on 28 November 2006 and entered into force on 1 January 2007. With later modifications and derogations, it still forms the basis of the EU VAT system today.

Despite the large extent of harmonization, the VAT rules applicable in the European Union are far from uniform. It has proved difficult to achieve political consensus among Member States because of countries' resistance to changes in the domestic tax systems. As unanimity is required for indirect tax measures,⁷⁸⁰ the policy-making process was driven by the need of compromise to satisfy demands of particular countries. To achieve support for VAT, controversial decisions were pushed into the future, national derogations accepted, and a wide range of exemption and reduced rates introduced.

Attempts to enact VAT outside the European Union revealed some shortcomings of the EU VAT model, especially multiple rates and various exemptions, the administration of which was beyond the capabilities of tax authorities in many countries. In 1985, New Zealand enacted what has become known as the modern VAT – a system that significantly improves the European model by applying a single rate, limited exemptions and a comprehensive base.⁷⁸¹ The modern VAT showed that it was possible to apply VAT to many types of supplies that are classified as too difficult to tax in the European Union. From the mid 1980s onwards, many countries have adapted the modern VAT or the European-style VAT system.

7.4 RISE OF ELECTRONIC COMMERCE

The birth of electronic commerce in the 1990s and the related acceleration of global trade had significant consequences for indirect taxation. As indirect taxes were conceived at the time when commerce meant local traders selling products to consumers in their brick-and-mortar shops, technological advances

780 Article 113 of the Treaty on the Functioning of the European Union (TFEU) of 13 Dec. 2007, OJ C115 (2008), reads as follows: "The Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition".

781 Goods and Services Tax Act 1985, Public Act 1985 No. 141.

and the emergence of new distribution models did not fit within the existing legal framework any more. Governments and legislators recognized that indirect taxes should be adapted in a coherent manner to the borderless world of global trade and a cooperative approach was required to solve common problems.

The first policy statements on electronic commerce were made in the United States and provided a stimulus for further debates on this new phenomenon. The US Treasury was the first tax administration to set out its views on tax policy implications of global electronic commerce. In its White Paper, published in November 1996, it concluded that the existing tax concepts had to be modified to address the problems raised by this new form of business.⁷⁸² As the White Paper was officially labeled a “discussion paper”, and given the state of the scholarship on this issue in those days, it provided more questions than answers.⁷⁸³

The international debate in respect of taxation issues arising from electronic commerce was largely driven by the OECD’s Committee on Fiscal Affairs (CFA). The OECD work can be traced back to November 1997 when a major international conference *Dismantling the Barriers to Global Electronic Commerce* was organized in Turku, Finland. Following the Turku Conference, the OECD prepared a framework for the taxation of electronic commerce that was presented at the Ottawa conference in October 1998.⁷⁸⁴ The Ottawa Report (1998) concluded that the same principles that governments apply to the taxation of conventional commerce should apply to electronic commerce. These principles included the well-known tax policy concepts of neutrality, efficiency, certainty, simplicity, effectiveness, fairness and flexibility. New legislative measures were not precluded, provided that they were intended to assist in the application of the existing taxation principles and not to impose a discriminatory tax treatment on electronic commerce transactions.⁷⁸⁵ The Ottawa Report (1998) recommended treating the supply of digitized products as a supply of services and to tax it in the country of consumption. International consensus had to be sought on the circumstances under which supplies were held to be consumed in a jurisdiction. Countries were advised to examine the use of reverse charge, self-assessment or other equivalent mechanisms for digital supplies acquired from suppliers outside the country.⁷⁸⁶

Following the Ottawa conference, five Technical Advisory Groups (TAG), consisting of government representatives from both OECD member and non-

782 US Treasury, *Selected Tax Policy Implications of Global Electronic Commerce* (22 Nov. 1996). The White Paper was quite conservative, rejecting the need for any radical rethinking of traditional tax concepts.

783 For a discussion of the White Paper, see R.S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 Tax L. Rev. 507 (1996/1997).

784 OECD, *A Borderless World: Realizing the Potential of Global Electronic Commerce* (1998).

785 *Id.*, at sec. 2.

786 *Id.*, at sec. 5.

member countries and business participants, were established to investigate policy solutions to the challenges raised by electronic commerce.⁷⁸⁷ The results of the work undertaken by the OECD and TAGs were published in the Implementation Report (2001).⁷⁸⁸ As regards consumption taxation, an important element of this Report was *Guidelines on the Definition of the Place of Consumption of Cross-Border Services and Intangible Property*.⁷⁸⁹ These Guidelines acknowledged that although electronic supplies should be taxed at the place of their actual consumption, this place might not be easily identifiable by the supplier. To prevent administrative difficulties and unnecessary compliance burdens, such services should be deemed to be supplied where the recipient had established his business (for B2B transactions) or where the person had his usual residence (for B2C transactions). However, it was recognized that there were no reliable means to verify that place.⁷⁹⁰ Another important part of the Implementation Report (2001) was *Guidelines on Tax Collection Mechanisms for Electronic Commerce*.⁷⁹¹ These Guidelines recommended the application of the reverse charge mechanism for cross-border B2B transactions. For B2C trade, it was recognized that no option was without significant difficulty. The registration of non-resident suppliers was suggested as an interim solution. However, countries wishing to apply this option had to ensure simplified registration procedure and the use of electronic VAT returns.

The European Union participated in the electronic commerce debate from the very beginning. In June 1998, the European Commission issued a *Communication on Electronic Commerce and Indirect Taxation*,⁷⁹² which intended to be the EU contribution to the Ottawa conference. The Communication concluded that VAT, as opposed to any new form of tax, was appropriate to be applied to electronic commerce. All supplies of goods and services within the European Union should be subject to the same tax, irrespective of the means of communication or commercial mode used to perform transactions. The Communication provided a set of guidelines that were to be used as a starting point for further discussions. The guidelines were as follows.⁷⁹³

787 For the description of the work of other TAGs, see section 1.4.3.1. OECD.

788 OECD, *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (2001).

789 *Id.*, at p. 44.

790 *Id.*, at p. 27. The Technology TAG found credit card-related information to be inaccurate as evidence of jurisdiction of the customer. The use of IP number also had limits in terms of its reliability and capacity to be manipulated. Finally, the Technology TAG pointed out increasing consumer sensitivity about personal privacy and data protection, both of which resulted in businesses being reluctant to seek to collect more information from customers than they needed for their commercial purposes.

791 *Id.*, at p. 46.

792 European Commission, *Communication on Electronic Commerce and Indirect Taxation*, COM(1998)374 final (17 June 1998).

793 *Id.*

- VAT must be adapted to the developments of electronic commerce. No new or additional taxes are to be considered.
- Supplies of digital products are considered to be supplies of services.
- Digital supplies made for consumption should be taxed in the European Union, irrespective of their origin. Similarly, services provided by EU operators in third countries should be not subject to VAT.
- Compliance should be made as easy as possible, for example, through the use of electronic invoices and VAT returns. At the same time, tax authorities must have sufficient tools for control and prevention of abuse.

In June 2002, the European Council adopted a directive which aimed at the implementation of some of the above-mentioned guidelines.⁷⁹⁴ The main features of the Electronic Services Directive (2002/38) were: new place-of-supply rules and a special regime for third-country suppliers of electronic services. Electronic services supplied by non-EU taxable persons to EU customers followed the destination principle. So did services supplied by an EU taxable person to another EU taxable person or a non-EU private person. However, the origin principle was maintained for supplies made by an EU taxable person to an EU private person. To reduce the compliance burden of third-country suppliers who were obliged to charge VAT of their customer's country, the Directive allowed them to register and submit their VAT returns by electronic means in only one Member State (the One Stop Shop scheme).⁷⁹⁵

Although the Electronic Services Directive (2002/38) improved the existing VAT system, it failed to provide a level playing field for taxable persons supplying electronic services to private individuals resident in the European Union. Whereas (until 1 January 2015) an EU taxable person needs to collect and remit VAT in the country where he is established (regardless of where the customer is resident), a non-EU business must charge VAT at the rate of the customer's country (although such VAT can be remitted to only one tax authority). To remove this disparity between EU and non-EU suppliers, new rules have to be implemented by the Member States by 1 January 2015.⁷⁹⁶ According to those rules, all providers of electronic services will charge VAT at the rate of the customer's country and apply the One Stop Shop regime.⁷⁹⁷

⁷⁹⁴ Council Directive 2002/38/EC of 7 May 2002 Amending and Amending Temporarily Directive 77/388/EEC as regards the Value Added Tax Arrangements Applicable to Radio and Television Broadcasting Services and Certain Electronically Supplied Services, OJ L 128 of 15 May 2002 (hereinafter: the "Electronic Services Directive (2002/38)"). Originally the Electronic Services Directive (2002/38) was intended to apply for a period of three years, starting from 1 July 2003. This period was extended many times and, finally, in 2008, the arrangements became permanent.

⁷⁹⁵ For the description of the One Stop Shop scheme, see section 8.1.9. *Administrative obligations*.

⁷⁹⁶ Council Directive 2008/8/EC of 12 February 2008 Amending Directive 2006/112/EC as regards the Place of Supply of Services, OJ L 44 of 20 Feb. 2008.

⁷⁹⁷ For more information on the rules applicable as from 1 January 2015, see section 8.1.4. *Place of taxation*.

Indirect tax issues of electronic commerce are one of the topics covered by the first action item of the OECD Base Erosion and Profit Shifting (BEPS) project.⁷⁹⁸ VAT collection on electronic services supplied by non-resident suppliers to final consumers is considered one of the biggest challenges created by the digital economy. The OECD published a discussion draft on taxation of the digital economy on 24 March 2014 and the final report is expected to be published in September 2014. Unfortunately, the OECD work within the BEPS project on VAT challenges of B2C supplies fails to provide new insights and mirrors the contents of the reports prepared by the OECD Consumption Tax TAG. In view of this fact, it is doubtful whether it will result in any significant changes.

The European Union has actively participated in the work underway at the global level within the OECD BEPS project. In order to identify and solve the key problems of taxation of the digital economy from an EU perspective, the European Commission established an Expert Group on Taxation of the Digital Economy. On 28 May 2014, the Expert Group presented its final report with some general conclusions (tax rules applicable to the digital economy should be stable, simple and neutral).⁷⁹⁹ The Group is of the view that the Commission and the Member States should commit to apply the destination principle to all supplies of goods and services and welcomes the expansion of the One Stop Shop arrangement as from 1 January 2015. In general, the views of the Expert Group are consistent with those expressed in the OECD BEPS reports.

7.5 THE MODEL TAX SYSTEM

7.5.1 Initial comments

This section describes the features of a model system for taxing transactions involving virtual currencies and items. Those features are identified on the basis of the general principles of taxation: neutrality, equity, certainty and administrative feasibility. Administrative concerns are an important criterion since a tax system must be capable of practical operation. The model indirect tax system is used as a benchmark to evaluate the EU VAT and US sales tax rules that apply to trade in virtual currencies and items. By comparing the model system with the existing legal framework of the two jurisdictions, recommendations for the improvement of the latter are made (*see* Chapter 9).

Section 7.5.2. describes the basic characteristics of the model indirect consumption tax system in terms of its object (consumption versus transactions), tax collection method (direct versus indirect) and place of taxation. Section

⁷⁹⁸ For more information on the BEPS project, *see* section 1.4.3.1. *OECD*.

⁷⁹⁹ Expert Group on Taxation of the Digital Economy, *supra* n. 20.

7.5.3. applies the fundamental principles of taxation (equity, neutrality, certainty and administrative feasibility)⁸⁰⁰ to determine how various elements of the model tax system (for example, person liable for tax remittance, place of taxation or taxable transactions) should be designed. The principles may overlap or conflict with one another, so that the design of the elements of the model tax system must be the result of a trade-off among them. It is also important to mention that the principles are not clear-cut criteria. For example, Brown and Mintz (2010) consider efficiency, equity and simplicity to be subcategories of neutrality.⁸⁰¹ The features of the model indirect tax system that are identified on the basis of the general principles are listed in section 7.5.4.

The fundamental principles of taxation must be distinguished from the purpose of tax. Taxes are generally used to pursue three different objectives: to raise revenue, to redistribute wealth and to encourage/discourage certain behaviour. As mentioned in section 7.3., consumption taxes were introduced solely with the purpose of raising revenue. They were not designed to meet social or redistributive objectives. Nor did they intend to discourage undesirable behavior. However, the purpose of a tax does not provide much information about the design of a tax system since a revenue-raising objective can be achieved in many different ways. The design of a tax system results from the principles underlying the tax.

7.5.2 Basic characteristics

7.5.2.1 Transaction tax

Indirect consumption taxes intend to cover expenditures made by private persons. Contrary to their name, they are not levied on consumption.⁸⁰² The term “consumption” merely indicated who bears the tax burden. The fact that some goods or services can be consumed quickly, whereas others (for example, equipment or the right to use immovable property) are used over a long period is irrelevant. The tax is due as soon as the consumer makes the expenditure, irrespective of when and how the goods and services will be used later on. The object of the tax is transactions performed by businesses, whereas the tax burden rests on consumers.

800 The same principles are discussed in the chapter describing the model income tax system (see section 4.3. *Principles of income taxation*).

801 C. Brown & J. Mintz, *On the Relationship between International Tax Neutrality and Non-Discrimination Clauses under Tax Treaties for Source-Based Taxes* in *Tax Treaties: Building Bridges between Law and Economics* (M. Lang et al. eds. IBFD 2010).

802 Terra & Kajus, *Introduction to European VAT (Recast)*, *supra* n. 766, at sec. 7.2.2.

7.5.2.2 Indirect tax

Consumption tax can be collected directly from consumers or indirectly from businesses supplying goods and services. Although in theory it is possible to designate the consumer as the person liable to remit the tax, such a direct consumption tax has nowhere proven its efficiency. In all countries, taxes on consumption are levied indirectly.⁸⁰³

The first reason for using businesses as tax collection points is that consumers are not subject to any registration and supervision mechanisms. Given the absence of system-inherent mechanisms that would ensure tax compliance, consumers would have an incentive not to remit the tax. The second reason is the large number of consumers in a jurisdiction (all citizens are consumers). Extending the tax collection obligation to consumers would cause a tremendous amount of work for the tax authorities and result in high administrative costs. The inefficiency of tax collection from customers is evidenced by the US experience with use taxes.⁸⁰⁴ Hellerstein (2003)⁸⁰⁵ refers to any tax that is self-assessed by consumers as a “tax on honesty”. The OECD stated in its various reports that consumer self-assessment is not an effective tax compliance mechanism.⁸⁰⁶

Taxing C2C transactions would face the same problems as levying income tax on imputed income. Imputed income is the value of benefits derived from non-market transactions.⁸⁰⁷ The administrative complexity associated with recording, reporting and auditing such income would make the tax system unworkable. Consequently, neither C2C transactions nor imputed income are taxed anywhere in the world.

Whereas it is acceptable to designate consumers as persons liable to remit the tax on an occasional basis (for example, in the case of cross-border acquisition of new means of transport in the European Union), the imposition of a general tax collection obligation on consumers would not be an efficient solution. Therefore, in the model system, businesses should be used as tax collection points since they are smaller in number and more likely to comply, and C2C transactions should remain outside the scope of tax.

803 Id., at sec. 7.2.3.

804 See section 8.2.4. *Basic characteristics of use taxes.*

805 W. Hellerstein, *Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective*, 38 *Georgia Law Review* 1 (2003), available at http://digitalcommons.law.uga.edu/cgi/viewcontent.cgi?article=1125&context=fac_artchop.

806 OECD, *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions*, p. 184 (2001).

807 See section 5.1.2.4. *Imputed income.*

7.5.2.3 Place of taxation

Two main principles that govern the inter-jurisdictional application of indirect consumption taxes are the destination principle and the origin principle. Under the former, goods are taxed where they are “consumed” (i.e. exports are exempt and imports are taxed on the same basis and with the same rates as local production). Under the latter, goods are taxed where they are produced (i.e. exports are taxed and imports are exempt).

The destination principle is regarded as the theoretically correct way to tax consumption since it ensures that all consumption within a particular jurisdiction is treated in the same way. Taxation according to the place of consumption is also supported by the benefit principle. Under this principle, the tax burden should be proportional to benefits that taxpayers obtain from the state. Those benefits include the provision of a legal and judicial system that protect the taxpayer’s possessions and the economic environment that renders consumption possible.⁸⁰⁸

However, even when the destination principle is applied, tax is not levied at the place of actual consumption. It is usually not possible to identify such a place at the time of the supply since the person who will “consume” the goods or services may not necessarily be the purchaser or at the time of the supply it may not be sure whether the goods will actually be consumed. All existing indirect tax systems use various proxies to predict the expected place of consumption (for example, the place where services are used and enjoyed, the permanent address or the usual residence of the customer).

7.5.3 Principles of taxation

7.5.3.1 Neutrality

Neutrality is the core principle underlying all tax systems. In both direct and indirect tax systems, this principle is supposed to provide a neutral background when taxpayers make a decision. A neutral tax situation does not have distortive effects on the economy. Taxes should neither influence business decisions nor affect consumer choices. Neutrality can be divided into external neutrality and internal neutrality.⁸⁰⁹

External neutrality is related to cross-border aspects of levying a consumption tax. In a neutral tax system, it should not make any difference whether

⁸⁰⁸ However, in certain cases (for example, when services are provided and consumed at the location of the service provider), it might not be entirely clear which state facilitates the consumption most.

⁸⁰⁹ Terra & Kajus, *Introduction to European VAT (Recast)*, *supra* n. 766, at sec. 7.3.

expenditure is related to goods imported or locally produced. Imported products should be treated in the same way as domestic products.⁸¹⁰

External neutrality is not ensured in cumulative cascade tax systems since the tax burden on a given product cannot be precisely determined. Nor is it guaranteed if goods and services from abroad escape taxation due to deficient tax collection mechanisms. In this regard, a concept of substantive and enforcement jurisdiction developed by Hellerstein (2003) can be useful.⁸¹¹ Substantive jurisdiction concerns the state's right to levy tax, whereas enforcement jurisdiction is related to the state's power to compel of the tax over which it has "substantive jurisdiction". Ideally, rules should be designed so that a state has either both types of jurisdiction or neither. If a state lacks enforcement jurisdiction, it will have difficulty collecting the right amount of tax and the principle of external neutrality will be violated.

Internal neutrality refers to national aspects of levying an indirect tax. It can be divided into legal, competition and economic neutrality. The concept of legal neutrality is closely connected to the legal character of consumption tax, and requires that the amount of tax payable is certain (i.e. expressed as a percentage of the retail price) and equal for similar (substitutable) products.⁸¹² Legal neutrality is guaranteed if all private expenditure is taxed. Taxes that target only specific types of supplies (for example, only supplies of tangible property) fail to observe that principle. Since services can be used as substitutes of goods and intangibles as substitutes of tangibles, excluding some types of supplies from taxation distorts economic decisions of individuals. For example, if taxes were levied only on printed books, the consumer would prefer to purchase electronic books instead. Tax systems that exclude services or intangibles from the tax base provide their consumers with incentives to use the tax-free products and discriminate against the taxed ones. Therefore, the model indirect tax system should be construed as a general tax that applies to all consumption expenditure.

Economic neutrality means that tax should not interfere with the optimal allocation of means of production and business decisions.⁸¹³ Such interference can be caused by different tax rates if, for example, the origin principle is applied and the tax rates are not uniform across countries. In such circumstances, production in low-tax jurisdictions is favoured.⁸¹⁴ In order not to influence business decisions, tax should not be a cost for businesses, but it should be shifted onto the final consumer. This aim can be achieved through

810 Id.

811 Hellerstein, *supra* n. 805, at p. 23; see also W. Hellerstein, *Jurisdiction to Tax in the Digital Economy: Permanent and Other Establishments*, 68 Bull. Intl. Taxn. 6/7 (2014).

812 Terra & Kajus, *Introduction to European VAT (Recast)*, *supra* n. 766, at sec. 7.3.1.1.

813 Id., at sec. 7.3.1.3.

814 If all countries had identical VAT systems, the origin and destination principles would become equivalent.

the right to deduct input VAT or through exempting B2B supplies from taxation (retail tax).

Competition neutrality means that taxation should not be influenced by the technology and commercial channels used for the supply of goods and services.⁸¹⁵ The tax burden should not be dependent on the degree of horizontal or vertical integration.⁸¹⁶ The market mechanism should determine the means of production and distribution. Competition neutrality is not guaranteed in cumulative cascade systems that favour integrated supply chains.

7.5.3.2 Equity

The principle of equity demands that the equal is treated equally and the unequal – in proportion unequally. There are two dimensions to the notion of equity: vertical and horizontal. Since horizontal equity overlaps with the principle of legal neutrality, reference is made here to section 7.5.3.1. Vertical equity means that people in different circumstances should pay an appropriately different amount of tax since it is fair for a heavier tax burden to fall on people who are better able to bear it.

Consumption taxes are levied irrespective of the personal circumstances of the taxpayer. They are said to be of regressive nature since the tax expenditure forms a larger part of expenditures of poorer households.

One obvious solution to implement the principle of vertical equity in consumption tax systems would be to introduce different tax rates for different people based on the resources available to them. This approach would guarantee that those with a greater ability to pay bear a higher tax burden. Needless to say, such a solution is unlikely to work in practice since suppliers would have to ask their customers about the applicable tax rate and have possibilities to verify that the communicated tax rate is correct.

Another solution to implement the principle of equity could be to apply reduced tax rates or exemptions to the basic necessities and products that are frequently purchased by poorer households. However, a differentiation of rates means that the well-off also pay less tax. Low tax rates on certain products benefit everyone and not only the target group. Another problem with multiple rates is that they tend to complicate the tax system by causing product misclassifications: suppliers of products at the dividing line of definition try to qualify their products as ones subject to the reduced rate. As a result, tax authorities must devote significant amount of time and resources to determine the correct tax rate in borderline cases. The most famous case on product classification is undoubtedly the Jaffa cakes, which made it necessary for the HMRC to issue the following guidance (the text of the guidance is reproduced

⁸¹⁵ Westberg, *supra* n. 21, at sec. 4.3.2.1.

⁸¹⁶ Terra & Kajus, *Introduction to European VAT (Recast)*, *supra* n. 766, at sec. 7.3.1.2.

in full to show the reader the type of questions that need to be answered to apply to correct tax rate):⁸¹⁷

‘The significance of the borderline between cakes and biscuits is that a cake is zero-rated even if it is covered in chocolate, whereas a biscuit is standard-rated if wholly or partly covered in chocolate or some product similar in taste and appearance. As set out in the paragraphs above, there is no generally accepted definition of either cake or biscuit, but the distinction is usually clear in practice.

Customs and Excise had accepted since the start of VAT that Jaffa cakes were zero-rated as cakes, but always had misgivings about whether this was correct. Following a review, the department reversed its view of the liability. Jaffa cakes were then ruled to be biscuits partly covered in chocolate and standard-rated: United Biscuits (as McVities, one of the largest manufacturers of Jaffa cakes) appealed against this decision. The Tribunal listed the factors it considered in coming to a decision as follows.

- The product’s name was a minor consideration.
- Ingredients: Cake can be made of widely differing ingredients, but Jaffa cakes were made of an egg, flour, and sugar mixture which was aerated on cooking and was the same as a traditional sponge cake. It was a thin batter rather than the thicker dough expected for a biscuit texture.
- Cake would be expected to be soft and friable; biscuit would be expected to be crisp and able to be snapped. Jaffa cakes had the texture of sponge cake.
- Size: Jaffa cakes were in size more like biscuits than cakes.
- Packaging: Jaffa cakes were sold in packages more similar to biscuits than cakes.
- Marketing: Jaffa cakes were generally displayed for sale with biscuits rather than cakes.
- On going stale, a Jaffa cake goes hard like a cake rather than soft like a biscuit.
- Jaffa cakes are presented as a snack, eaten with the fingers, whereas a cake may be more often expected to be eaten with a fork. They also appeal to children, who could eat one in a few mouthfuls rather like a sweet.
- The sponge part of a Jaffa cake is a substantial part of the product in terms of bulk and texture when eaten.

Taking all these factors into account, Jaffa cakes had characteristics of both cakes and biscuits, but the tribunal thought they had enough characteristics of cakes to be accepted as such, and they were therefore zero-rated.’

If certain goods or services were exempt from tax for social policy reasons, the same problems of classification would arise. Moreover, in indirect tax systems that use the invoice-credit method, the application of exemptions creates difficulty in calculating the proportion of deductible input tax.

817 HMRC, VFOOD6260 – *Excepted items: Confectionery: The bounds of confectionery, sweets, chocolates, chocolate biscuits, cakes and biscuits: The borderline between cakes and biscuits*, available at: <http://www.hmrc.gov.uk/manuals/vfoodmanual/vfood6260.htm>.

The above-mentioned arguments show that equity cannot be easily achieved in an indirect tax system. The policy measures to make an indirect tax system equitable would compromise its simplicity (multiple rates causing classification problems) or even jeopardize its operation in general (the application of different tax rates to different taxpayers depending on their ability to pay). It can be concluded that consumption tax is not the appropriate tool to pursue equity objectives and that certain features of the tax system (reduced rates and exemptions) are undesirable.

7.5.3.3 *Administrative feasibility and certainty*

An administrable tax system is efficient, simple and certain. Efficiency means that compliance costs for taxpayers and administrative costs for the tax authorities are minimized.

Administration costs are frequently determined by the number of taxpayers and the extent of compliance obligations. The use of high registration thresholds reduces the number of taxpayers that must register and fulfill administrative obligations. It means less frequent audits and less work for the tax administration. The main reason for excluding businesses with low turnover from the tax scope is that tax revenue from their activity is not likely to exceed the related administrative and compliance costs. On the other hand, a high threshold may be regarded as giving an advantage to small enterprises and creating distortion of competition with larger ones. Thus, the level of the threshold is often a compromise between the desire to reduce compliance and collection costs and the desire not to jeopardize tax revenue and not to distort competition.⁸¹⁸

In an efficient tax system, the key role of businesses in tax collection must be properly recognized since indirect taxes are intended to be borne by consumers and not by businesses. As taxation of B2B supplies does not generate any revenue for the state (except if the business customer cannot deduct input VAT), the least burdensome rules should be applied for B2B transactions.

Tax rules are simple and certain when taxpayers can easily determine in advance who, when and how has to pay the tax. Taxpayers must understand and anticipate the tax consequences of their actions. In indirect consumption tax systems, certainty should be reflected in the rules determining the personal scope of tax, the types of taxable transactions and the place of supply.

First, taxpayers must be sure when they become obliged to charge and remit tax. Some countries require a case-by-case analysis to identify whether a person is engaged in business activity that triggers the obligation to account for consumption tax. Others impose a tax collection obligation if certain turnover thresholds are met. The latter approach provides taxpayers with legal certainty since the sales volume is an objective fact, whereas the outcome of

818 OECD, *Consumption Tax Trends*, ch. 3 (2008).

a case-by-case analysis depends on the person who performs it. On the other hand, a threshold may be perceived as unfair by taxpayers whose turnover has just exceeded it.

Second, the types of taxable transactions should be clearly defined. If an indirect tax covers all transactions, taxpayers do not need to consider whether their supplies are taxable. However, if only certain supplies are taxed (for example, supplies of tangible property and selected intangibles), it is necessary to determine the exact nature of each supply. It may occur that the characterizations chosen by the taxpayer and the tax authorities diverge.

Finally, the application of the destination principle makes it necessary to establish the place of consumption on a case-by-case basis. To keep the compliance burden related to this task manageable and prevent uncertainty, tax legislation should establish proxies for the place of consumption that are clear and available to suppliers at the time of the transaction (for example, it is easier for the supplier to identify the shipping address than the place when a service is actually used and enjoyed).

7.5.4 Interim conclusions

To sum up, the characteristics of the model system for taxing virtual currencies and items that have been identified in this chapter on the basis on the principles of taxation are as follows:

- The personal scope is clearly defined, so that there is no uncertainty regarding who has to remit the tax.
- All supplies of goods and services are taxable (i.e. within the scope of tax) and taxed (i.e. not exempt) to eliminate classification issues that may unnecessarily complicate the tax system.
- The destination principle applies to determine the place of taxation. The place of consumption is identified on the basis of clear proxies that are available to the supplier at the time of the transaction. The effective-use-and-enjoyment criterion is avoided.
- Multiple rates are avoided. One rate applies to all digital products.
- Tax burden rests exclusively on consumers, whereas B2B supplies are excluded from the scope of tax or input tax deductions are available.
- Tax collection system is effective and efficient. Non-compliance risks prevalent in certain sectors or among certain groups of taxpayers are eliminated. There are mechanisms in place to ensure that all suppliers comply with their tax obligations.

These characteristics are used as a benchmark in the evaluation of the indirect tax systems of the European Union and the United States. Both systems are described in Chapter Eight (*see* section 8.1. for EU VAT and section 8.2. for US sales tax). To ensure their comparability and consistency, both sections have

a parallel structure and are organized according to the elements of the tax system. Chapter Nine identifies discrepancies and mismatches between the model tax system described in this chapter and the actual tax systems described in Chapter Eight and makes recommendations to remedy them.