**Taxation of virtual currency**
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# 8 Indirect tax: country-specific considerations

## 8.1 The European Union

### 8.1.1 Sources of EU VAT law

VAT is an important pillar in the tax and economic system of the European Union. Apart from being a significant revenue source, it contributes to a non-distortive trade policy and respects the fundamental freedoms. VAT legislation in the European Union has been harmonized to a large extent to ensure the proper functioning of the internal market. This process started in 1967, when the First and the Second VAT Directive were enacted.[819] Currently, the VAT Directive[820] lays down the fundamental concepts of the VAT system. The majority of its provisions is straightforward and leaves no discretion with regard to their implementation; however, some allow certain leeway in adopting national rules.[821] To ensure uniform application of the VAT Directive, the VAT Implementing Regulation[822] was enacted.[823] However, the large number of VAT cases referred to the Court of Justice of the European Union (ECJ) indicates that the EU VAT system is far from being clear and uniform.

Decisions of the Court of Justice of the European Union play a fundamental role in the application of the EU VAT rules. The ECJ is "the supreme court" in

819 *First Council Directive 67/227/EEC of 11 April 1967 on the Harmonization of Legislation of Member States Concerning Turnover Taxes* and *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.

820 *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").

821 For example, Member States may decide about the applicable VAT rates. The VAT Directive only lays down the minimum standard rate (15%) and the minimum reduced rate (5%).

822 *Council Implementing Regulation (EU) No 282/2011 of 15 March 2011 Laying Down Implementing Measures for Directive 2006/112/EC on the Common System of Value Added Tax*, OJ L77 of 23 Mar. 2011 (hereinafter: the „VAT Implementing Regulation"). In 2013, the VAT Implementing Regulation was amended by *Council Implementing Regulation (EU) No 1042/2013 of 7 October 2013 amending Implementing Regulation (EU) No 282/2011 as regards the place of supply of services*, OJ L 284/1 of 26 Oct. 2013. When this thesis mentions the VAT Implementing Regulation, it refers to the amended version.

823 Regulations are binding in their entirety and are directly applicable in all Member States. In contrast, a directive is binding as to the result to be achieved, allowing each Member State to choose the method and form of its implementation.

EU VAT matters, since it has the main responsibility for ensuring that VAT law is interpreted and applied in the same way in all EU countries. The ECJ makes sure that national courts do not give different rulings on the same issue and that Member States and EU institutions do what the law requires. Most matters brought before the Court are either references for preliminary rulings or direct actions. Preliminary rulings result from requests by Member States' national courts for the ECJ to give guidance on the interpretation of EU law. Direct actions are usually brought by the European Commission against Member States that have failed to fulfill their obligations under EU law. The ECJ is acknowledged to have been the driving force in the emergence of a distinctive "European Union law", separate from both national and traditional international law. The ECJ proclaimed this law to be "a new legal order" in *NV Algemene Transporten Expeditie Onderneming van Gend en Loos v. Nederlandse Administratie der Belastingen* (26/62).[824] Moreover, this new legal order was accorded supremacy over the national laws of the Member States in *Flaminio Costa v. ENEL* (6/64).[825]

In simple terms, the functioning of the VAT system can be described as follows. All supplies of goods and services carried out for consideration by a taxable person in the EU territory are subject to VAT, unless a specific exemption applies. VAT charged by the supplier to his customers is known as "output VAT". The supplier is generally responsible for the remittance of output VAT to the tax authorities. VAT paid by the supplier to other businesses on goods and services that he receives is known as "input VAT". A taxable person is generally able to recover input VAT attributable to his taxable transactions by setting it off against the output VAT in his VAT return, provided that all the requirements for an input VAT deduction are met.

### 8.1.2 Taxable person

In order to determine the personal scope of VAT, it is necessary to establish who may be regarded as a taxable person. "Taxable person" is an autonomous VAT concept. It does not exist in civil or trade law. Under article 9 of the VAT Directive, a taxable person is anyone who independently carries out in any place any economic activity, whatever the purpose or result of that activity. Article 9(2) provides a non-exhaustive list of economic activities ("any activity of producers, traders, person supplying services, including mining and agricultural activities and activities of the professions"), and notes that "exploitation of tangible or intangible property for the purposes of obtaining income therefrom on a continuing basis" should also be taxable.

824 ECJ, 5 Feb. 1963, 26/62, *NV Algemene Transport- en Expeditie Onderneming van Gend & Loos v Netherlands Inland Revenue Administration.*
825 ECJ, 15 July 1964, 6/64, *Flaminio Costa v. ENEL.*

Thus, the definition of the taxable person is very broad: it is not limited to EU residents ("any person in any place") or to persons acting for profit motives ("whatever the purpose"). This is in line with the objective of VAT as a general consumption tax. The characterization as a taxable person depends on two factors: the existence of economic activities and the independent pursuit of such activities. The former requirement is examined in the next sections. The latter is not discussed further as persons trading in virtual items and currencies do not perform these activities in an employment relationship.[826] Thus, they act independently.

#### *8.1.2.1 Beginning of economic activities*

A person may acquire the status of a taxable person long before he first performs a taxable transaction. The ECJ ruled in *Rompelman* (C-268/83) that the exploitation of property generally begins "with the first preparatory act, i.e. with the first transaction on which input tax may be charged".[827] Any other view would be contrary to the purpose of the VAT system since in the period between the remittance of VAT which is payable on the first transaction and the refund of that VAT, the person would bear the tax burden; however, the intention of the VAT system is precisely to relieve the trader entirely of that burden.[828] Thus, preparatory activities, such as the acquisition of operating assets, must be treated as economic activities. Nevertheless, the tax authorities may require that the declared intention to perform taxable supplies is supported by objective evidence.[829]

It is not relevant whether the acquired assets are immediately used for taxable transactions.[830] The immediate use of goods for taxable supplies does not constitute a condition for the existence of an economic activity. As the ECJ observed in *Lennartz* (C-97/90), the use to which the goods are put, or intended to be put, merely determines the extent of the initial deduction to which the taxable person is entitled. However, it is the acquisition of the goods by a taxable person acting as such that gives rise to the application of the VAT system and the deduction mechanism.[831] To determine whether a person acquires goods in his capacity as a taxable person, all relevant circumstances,

826 Under article 11 of the VAT Directive, "the condition in Article 9(1) that the economic activity be conducted 'independently' shall exclude employed and other persons from VAT in so far as they are bound to an employer by a contract of employment or by any other legal ties creating the relationship of employer and employee as regards working conditions, remuneration and the employer's liability".

827 ECJ, 14 Feb. 1985, C-268/83, *D. A. Rompelman and E. A. Rompelman-Van Deelen v. Minister van Financiën*, para. 13.

828 Id.

829 Id., at para. 25.

830 ECJ, 11 July 1991, C-97/90, *H. Lennartz v. Finanzamt München III*, para. 14.

831 Id., at para. 15.

such as the nature of the goods concerned and the period which elapsed between their acquisition and their use for the taxable person's economic activities, must be taken into account.[832]

Trade in virtual items and currencies usually starts as a hobby: people explore virtual worlds for fun. The first sales of virtual items are made on an occasional basis, whenever a favourable opportunity occurs. As players become more experienced, they are able to find more good sales opportunities and to increase their trade volume. It is difficult to establish when play ceases and taxation may begin: the transition from non-taxable hobby to business activity may take a long period.

According to the settled ECJ case law, the intention to perform taxable transactions must be confirmed by objective evidence. What kind of evidence can qualify as sufficient is unclear. Some preparatory activities, such as the purchase of gaming software, may be considered to be part of both an economic activity and a new hobby. In general, creating a game account or a virtual wallet should not be sufficient evidence that taxable transitions will be carried out in the future. However, the registration as a seller with an exchange platform where virtual items can be traded, the opening of a virtual shop in *Second Life* or the installation of bitcoin mining software may indicate that a person prepares to carry out economic activity.[833]

To sum up, in the case of activities that may be performed for both private and business purposes, it is very difficult to establish when the business element prevails. The term "objective evidence" is actually of subjective nature since every person may have different opinion on what is "objective enough". It is clear that some activity must be carried out: the mere intention to make a virtual business out of a virtual presence is not sufficient. Although some indicators can be found, it is not possible to consider their existence to be an unequivocal sign that taxable activities are likely to occur.

#### *8.1.2.2 Purpose and result of economic activities*

Under article 9 of the VAT Directive, an activity may be considered an economic one, irrespective of its purpose or result. According to the Advocate General (AG) opinion in *Hong Kong Trade Development* (C-89/81), the expression "whatever the purpose or result" ("whether or not for gain")[834] is only explanatory

832 Id., at para. 20.
833 It is assumed here that a person does not already qualify as a taxable person due to other circumstances.
834 The case was decided on the basis of the Second VAT Directive. Article 4 of that Directive defined the taxable person as "any person who independently and habitually engages in transactions pertaining to the activities of producers, traders or persons providing services, whether or not for gain".

and of secondary importance. It merely intends to clarify that not the aim but the nature of the activities in question is relevant.[835]

An activity does not cease to be an economic one because it is loss-making or carried out for a charitable or philanthropic purpose. The ECJ held in *Hotel Scandic Gåsabäck AB* (C-412/03) that the fact that the price paid for an economic transaction is higher or lower than the cost price is irrelevant.[836] In *Enkler* (C-230/94), the ECJ stated that the hiring out of the caravan could be an economic activity despite that fact that it resulted in losses.[837] The indifference towards profit making is consistent with the nature of VAT: whether a profit is made is irrelevant, it is private expenditure made for consumption what counts.

In *SPÖ Landesorganisation Kärnten* (C-267/08), the question was whether public relation activities and supply of advertising material carried out by a section of a political party could be viewed as economic activities. The ECJ answered the question in the negative. In the judgment, it referred to the fact that "the exploitation does not allow the generation of revenue on a continuing basis" and income from other sources (party members' contributions and public funding) had to be raised "to cover losses made by the activity at issue".[838] However, this statement cannot be used to conclude that a loss-making activity cannot be an economic activity. The decisive argument for the ECJ was that SPÖ did not participate in any market. Its task was to spread ideas as a political organization. The fact that it was financed by subsidies from public funds was in accordance with the Austrian legislation on the financing of political parties.

In contrast to the income tax legislation of many European countries, VAT does not require a profit motive. The argument that no profits are or will be made cannot be used to deny the status of a "taxable person". However, the statement "whatever purpose or result" cannot be interpreted as meaning that a hobby purpose is sufficient. According the settled ECJ case law, the economic nature of the activities is decisive. The next sections try to shed more light on the interpretation of this concept.

### *8.1.2.3 Duration of economic activities*

It is apparent from the settled case law that the term "economic activities" is very broad and objective in character.[839] From article 12 of the VAT Directive, it may be deduced that economic activities should be carried out on more

835 AG Opinion, 2 Mar. 1982, C-89/81, *Staatssecretaris van Financiën v. Hong Kong Trade Development Council*, para. 33.
836 ECJ, 20 Jan. 2005, C-412/03, *Hotel Scandic Gåsabäck AB v. Riksskatteverket*, para. 22.
837 ECJ, 26 Sep. 1996, C-230/94, *R. Enkler v. Finanzamt Homburg*.
838 ECJ, 6 Oct. 2009, C-267/08, *SPÖ Landesorganisation Kärnten*, paras. 21 and 25.
839 Id., para. 17 with further references.

than an occasional basis since occasional transactions *may* be included in the concept of a taxable person if Member States decide so. This same continuity requirement is found in article 9(2) of the VAT Directive regarding the exploitation of tangible and intangible property.

However, this should not be understood as meaning that one needs to enter into several transactions to qualify as a taxable person. The Advocate General clarified this matter in the case *Wellcome Trust* (C-155/94). The Wellcome Trust Ltd was the sole trustee of a charitable trust. It sold a large amount of shares that it had held for several years and reclaimed input tax on expenses incurred in relation to that sale. The transaction took place on one day; however, it required extensive preparatory work and assistance of investment advisors. The question was whether the company's investment activities constituted economic activities. The AG observed that the fact that the shares were sold during one day had no bearing on the assessment of that sale. If an activity is treated as an economic activity within the meaning of the VAT Directive, it will remain so even if completed in a single day. The AG concluded that "it is neither the scope nor the duration which is conclusive, but solely the question whether that activity is an economic activity".[840] The ECJ followed the AG's reasoning in its judgment.

There seems to be some inconsistency between the ECJ case law and the wording of the VAT Directive. Under the former, a one-time transaction is sufficient, whereas under the latter, occasional activities may be regarded as economic ones only if a Member State decides so.

The decisive element for the characterization as a taxable person is the economic nature of activities. The term "economic" literally means "considered in relation to trade, industry" or "justified in terms of profitability".[841] Thus, a literal interpretation of this concept suggests that several transactions must be carried out. A person is not considered to be a trader by making a single sale. The fact that there are no guidelines on what number of transactions is required or during what period they must occur to qualify as economic ones creates significant legal uncertainty. What if the activities are related but there is a large time break between them? For example, a person sells five virtual items in his virtual shop during one week and then makes another five sales during another week in four months. As continuity is not required, such time breaks should be irrelevant. However, adding up several occasional sales seems to contradict the wording of the VAT Directive, which excludes such transactions from the VAT scope.

840 AG Opinion, 7 Dec. 1995, C-155/94, *Wellcome Trust Ltd v. Commissioners of Customs & Excise*.
841 Oxford Dictionary, http://oxforddictionaries.com/definition/english/economic?q=economic.

### *8.1.2.4 Exploitation of property*

Under article 9 of the VAT Directive, a person exploiting tangible or intangible property must act with the purpose of obtaining income from such activities on a continuing basis. The term "exploitation" refers to all transactions, irrespective their legal form.[842] However, to be subject to VAT, the exploitation must meet two requirements: its purpose must be to obtain income (condition one) on a continuing basis (condition two).[843] The ECJ shed more light on the interpretation of those requirements in *Ainārs Rēdlihs* (C-263/11),[844] *Enkler* (C-230/94), *Słaby* (C-180/10) and *Kuć* (C-181/10).[845]

Mr. Rēdlihs carried out 12 supplies of timber in April 2005 and 25 transactions of the same type between May 2005 and December 2006. He was not as registered as a taxable person and did not declare any economic activity to the tax authorities, as, in his view, his transactions were non- systematic, of an exceptional nature and not made for profit (he supplied timber to alleviate the damage caused by a storm).

Mrs. Enkler was employed in her husband's tax consultancy firm. She notified her local tax authorities that she was also carrying on the business of hiring out motor caravans. During three fiscal years, she hired out the vehicle, which was mainly used for private purposes, only twice to third parties. Mrs. Enkler did not advertise that the motor caravan was available for hire. When it was not out on hire, the vehicle was kept in a covered parking area near the building where the Enklers lived.

Mr. Słaby purchased, as a natural person not carrying out any economic activity, land designated under the urban management plan for agricultural purposes. He used that land accordingly. When the plan was changed and the land in question was earmarked for a holiday home development. Mr. Słaby divided the land into 64 plots and began to sell them to private individuals. Mr. and Mrs. Kuć purchased land not permitted for development and used it for agricultural purposes. Following a change to the urban management plan, according to which the land in question was henceforth earmarked for residential and service development, they began to sell plots on an occasional and non-organized basis. In both cases, the question was whether the sale of land plots could be regarded as an economic activity or whether it was merely a non-taxable sale of private property.

In all the cases, the ECJ held that the question of whether an activity (the exploitation of a private forest, land or hiring out of a caravan) is designed

842 ECJ, 4 Dec. 1990, C-186/89, *W.M. van Tiem v. Staatssecretaris van Financiën*, para. 18.

843 If the latter requirement is not fulfilled, the exploitation of property on an occasional basis may nevertheless qualify the person as a taxable person based on article 12 of the VAT Directive.

844 ECJ, 19 July 2012, C-263/11, *Ainārs Rēdlihs v. Valsts ieņēmumu dienests*.

845 ECJ, 15 Sep. 2011, joined cases C-180/10 *Jarosław Słaby v. Minister Finansów* and C-181/10 *Emilian Kuć and Halina Jeziorska-Kuć v. Dyrektor Izby Skarbowej w Warszawie*.

to obtain income on a continuing basis is an issue of fact which must be assessed having regard to all the circumstances of the case, including, inter alia, the nature of the property concerned. The fact that property is suitable only for economic exploitation will normally be sufficient for a finding that its owner is exploiting it for the purposes of economic activities. However, if property is capable of being used for both economic and private purposes, all the circumstances in which it is used must be examined in order to determine whether it is actually being used for the purpose of obtaining income on a continuing basis. One way of ascertaining that is to compare circumstances in which the person concerned actually uses the property with the circumstances in which the corresponding economic activity is usually carried out.

The ECJ repeated that the mere exercise of the right of ownership by its holder cannot, in itself, be regarded as an economic activity. The number and scale of the sales are not decisive for distinguishing between activities in a private capacity and those of a taxable person. A large volume of sales may also be carried out by private individuals. Similarly, the fact that, prior to the disposal, the party concerned proceeded to divide the land into plots in order to obtain a higher overall price from that land, the period of time over which those transactions took place and the level of income derived therefrom are not decisive for the existence an economic activity as all those circumstances could also fall within the scope of the management of the personal property. The occurrence of such activities may only be a useful indication that one is acting a taxable person.

However, a person may be assumed to carry out economic activities in the situation where he takes active steps to market property by mobilizing resources similar to those deployed by a producer or trader. Since those initiatives do not normally fall within the scope of the management of personal property, they cannot be regarded as the mere exercise of the right of ownership by its holder.

In *Wellcome Trust* (C-155/94), the ECJ concluded that the activity of the trust was similar to that of a private individual managing its own assets. Neither the scale of the sale of shares nor support from consultancy firms could change that. Whether an investor is in a position to carry out his investment activity himself or whether he requires the assistance of one or more advisers in that regard is not relevant. Otherwise, the characteristics and skills of the investor would determine whether an economic activity ought to be assumed.

Form the above-mentioned case law, it can be concluded that also in the case of exploitation of property there are no clear-cut criteria for identifying the taxable person: the scope and volume of transactions are not decisive. Instead, the vague requirement of economic nature, which should be established on a case-by-case basis, is used. This approach will inevitably result in divergent interpretations of "economic nature", which will finally lead to turning this (intended as objective) concept into a subjective one.[846] "Objective" means "not influenced by personal feelings or opinions in considering and representing facts".[847] By definition, an objective outcome should not result from an individual case-by-case approach by judges and tax administrators.

#### *8.1.2.5 Acting as such*

It is clear from the wording of article 2(1) of the VAT Directive that a taxable person must act "as such" for a transaction to be subject to VAT. When a taxable person makes a supply which is not part of his economic activity, the supply is not taxable. The taxable person may choose whether to retain an item among his private assets, excluding it from the VAT system or to integrate it into his business.[848] However, the taxable person must, throughout his period of ownership of the property in question, demonstrate an intention to retain it amongst his private assets.[849] The ECJ declared in *Galin Kostov* (C-62/12)[850] that a natural person who already qualifies as a taxable person for his normal activities (as a self-employed bailiff) may also qualify as such in respect of any other economic activity carried out occasionally.

Since many people visit more than one virtual world, it is possible that they use one virtual world for taxable activities and another as a hobby. An even more extreme scenario is when a person splits his virtual presence into a business and private component. For example, he may have a virtual shop which is used to carry out taxable sales and, in addition to that, sell his virtual personal items from time to time. Drawing a line between the business and private sphere is extremely difficult in such a case and cannot be done without a careful examination of all the relevant facts. It is doubtful whether tax authorities would agree with such split of the virtual presence. More likely, they would treat all income derived from online environments as taxable once it is established that a part of it is taxable.

#### *8.1.2.6 National case law*

The term "taxable person", as the fundamental VAT concept existing since the introduction of the common EU VAT legislation, should be sufficiently clear

846 The ECJ held on various occasions that the terms "taxable person" and "economic activities" must be objective in character. ECJ, 21 Feb. 2006, C-255/02, *Halifax plc, Leeds Permanent Development Services Ltd and County Wide Property Investments Ltd v Commissioners of Customs & Excise*, para. 55.

847 Oxford Dictionary, http://oxforddictionaries.com/definition/english/objective?q=objective.

848 ECJ, 4 Oct. 1995, C-291/92, *Finanzamt Uelzen v. Dieter Ambrecht*, paras. 16-20.

849 Id. at para. 21.

850 ECJ, 13 June 2013, C-62/12, *Galin Kostov v. Direktor na Direktsia 'Obzhalvane i upravlenie na izpalnenieto' – Varna pri Tsentralno upravlenie na Natsionalnata agentsia za prihodite*.

and unambiguous. However, it is far from that. Numerous ECJ judgments have not helped to clarify this concept either. The lack of precision in the definition of the taxable person at EU level translates into uncertainty at national level and to unexpected consequences for taxpayers. Three German cases (car collector, eBay seller and card player), which involve making a distinction between a hobby and an economic activity, illustrate this.

*Car collector*

A car enthusiast established a limited liability company, the aim of which was the purchase of classic automobiles and their resale after 20 years (to profit from their increase in value). From 1986 to 1991, the company purchased 126 cars and stored them in an underground garage. Two of the cars were sold during that time. The company also planned to develop a roadster. For this purpose, it hired an engineer and had the model name protected by intellectual property rights. When it turned out that the use of the roadster would not be allowed under road traffic regulations, only one copy of the car was produced.

The contentious issue was the right to input VAT deduction. The tax authorities claimed that the company did not carry out any economic activity, but was used to create a private car museum.[851] They pointed out that neither a sound business plan (showing the expected profits or turnover) was developed nor the market investigated. The Tax Court of Hessen (*Finanzgericht Hessen*) rejected the claim of the tax authorities and confirmed the existence of economic activities.[852] Based on the examinations of all the relevant circumstances of the case, it concluded that the company had developed a unique business concept and followed it consequently.

The Federal Tax Court (*Bundesfinanzhof*, BFH) reversed the decision of the Tax Court.[853] To determine whether the activity in question was designed to obtain income on a continuing basis, the Court referred to the *Enkler* (C-230/94) case, in which the ECJ stated that this issue must be assessed having regard to all the circumstances of the case including, inter alia, the nature of the property concerned. The Federal Tax Court concluded that the concept of economic activities required that the taxpayer acted as an entrepreneur (taxable person) while building up his car collection. In the case in question, the company planned to sell the cars after 20 years. Thus, during those years, it did not act as an entrepreneur but as a private person. The idea to construct a roadster was, according to the Court, very risky and of speculative nature and, for that reason, it was not likely to constitute economic activities either. More-

851 Under sec. 2 of the German VAT Act, each activity carried out on a continuing basis for the purposes of generating income therefrom shall be regarded as an economic activity, even where the intention of generating a profit is absent.

852 FG Hessen, 22 Apr. 2009, 6 K 2821/02.

853 BFH, 27 Jan. 2011, V R 21/09.

over, no detailed calculations of production costs and revenues were made. Another fact that was used to deny the performance of economic activities was that the company did not have business premises. The underground garage was not considered as such as it was merely used to store the cars and not to perform sales and marketing activities. No sign with the company name was present there either. Thus, the intention of the company to perform taxable activities in the future could not be confirmed by objective evidence.

In the car collector case, two courts reached a different conclusion based on the examination of the same facts and following the same ECJ guidelines of the *Enkler* (C-230/94) case. The Federal Tax Court denied the existence of economic activities as "no resources similar to those deployed by a trader" were used. It was not important that: there were sound reasons for the sale to occur after 20 years, the cars were acquired and properly stored, the name of the roadster was registered as a trade mark and professionals were hired to assist with its development. Instead, the Court focused on the existence of business premises and the risky nature of the enterprise (criteria not directly mentioned by the ECJ). Surprisingly, it did not refer to the ECJ judgment in *Lennartz* (C-97/90), according to which the acquired assets do not have to be immediately used for taxable transactions. Nor did it comment how the findings from the *Rompelman* (C-268/83) case would impact the case in question.

*EBay seller*

In 2012, the German Federal Tax Court had to answer the question when a private individual selling goods on eBay becomes a taxable person.[854] The facts of the case were as follows: from November 2001 to June 2005, a married couple sold 1,200 goods (stamps, coins, carpets and cutlery) on eBay and achieved total revenue of more than EUR 110,000.[855] The tax authorities considered this an economic activity as the transactions were carried out to obtain income on a continuing basis. The couple claimed that they just wanted to get rid of some items that they did not need any more. Those items were acquired without the intention of resale. The sales did not require any organizational effort: items were simply put on eBay without being advertised or marketed in any way. The couple used their private eBay account and did not register any commercial activity.

The Federal Tax Court held that the transactions in question constituted taxable economic activities. First, the Court pointed out that the concept of economic activities is very broad. Second, it recalled that under the settled

854 BFH, 26 June 2012, V R 2/11.

855 The amounts of revenue were as follows: DM 2,600 (2001), EUR 25,000 (2002), EUR 28,000 (2003), EUR 21,000 (2004) and EUR 35,000 (2005). In Germany, the special regime for small enterprises applies if the total turnover did not exceed EUR 17,500 in the preceding calendar year and will not be higher than EUR 50,000 in the current year (sec. 19 of the German VAT Act).

ECJ case law, a person may be assumed to carry out economic activities in the situation where he takes active steps to market property by mobilizing resources similar to those deployed by a producer or trader. Those initiatives do not normally fall within the scope of the management of personal property, so they cannot be regarded as the mere exercise of the right of ownership by its holder. The Court ruled that the assessment of the activity in question must be made on the basis of the overall circumstances of the case. To distinguish private asset management from economic activity, the following factors are of vital importance: duration and frequency of the transactions, turnover, market participation, structured and planned performance of the activity. However, it is not possible to set a monetary threshold below which transactions are considered to be private asset management. The fact that the items were not purchased for resale cannot be decisive for denying economic activities. The Court pointed out that the couple used a commercial distribution system (eBay) and that the activities required considerable organizational effort: the couple had to describe each item, put it in the correct category and provide a photo of it. Moreover, the sellers had to monitor the website to respond to any enquiries of potential customers. When an item was sold, it had to be packed and sent to the recipient.

The reasoning of the Federal Tax Court in the eBay case can be criticized on several grounds. The sale of items on eBay was motivated by private needs (to give away obsolete personal items). The decisions on which item to sell were made spontaneously, without prior plan and irrespective of the situation on the market. It must be recalled from the *Wellcome Trust* (C-155/94) case that "neither the scope nor the duration" is decisive for the presence of economic activities.

In the car collector case, the lack of a detailed business plan and business premises was an indication that no economic activities took place. However, it did prevent the Federal Tax Court from concluding that eBay sellers acted as taxable persons. For the Federal Tax Court, spontaneous sales of old personal items on eBay apparently require more effort than the purchase and storage of 126 cars since it held that only in the eBay case "resources similar to those deployed by a producer or trader" were mobilized. This reasoning is hard to follow.

*Card player*

The Federal Tax Court had to answer the question whether a card player was a taxable person.[856] The case concerned a person who frequently visited casinos during the period 1982-1985 and played different card games there. The player was present at the casino during fixed times which were known to people who were interested in playing cards with him. He usually played

856 BFH, 26 Aug. 1993, V R 20/91.

with the same group of people. The tax authorities considered his activity to be an economic one and required him to remit VAT on the services he provided. They estimated the player's turnover to be DM 49,500 (1984) and DM 54,000 (other years).[857]

The Federal Tax Court first observed that the player provided services consisting of playing cards with others according to the agreed rules. The consideration was performance-dependent and consisted of money that was at stake. Based on the duration and frequency of the activity, the Court concluded that the player was a taxable person.

This decision shows that for the Federal Tax Court, the fact that an activity is generally regarded as a hobby does not have any influence on its VAT treatment. A hobby card player may turn into a professional player (taxable person) if his activity has certain intensity and frequency. Unlike in the car collector case, the Court did not pay any attention to the nature of the activities and to the fact that the outcome of card games could be speculative and dependent on factors beyond the player's control. From the analysis of the three German cases, it can be concluded that turnover and frequency of transactions are the decisive criteria in determining whether a person becomes a taxable person.

Given the importance of turnover, it is surprising that there are still no definite turnover thresholds below which a person will neither be considered as a taxable person nor have to fulfill any VAT obligations. Many Member States (including Germany) apply "registration thresholds" which mean that persons whose turnover is below a certain amount do not have to charge VAT ("small enterprises"). However, small enterprises do have to register if they render services to taxable persons established in other Member States and those services are deemed to be supplied in the customer's country or receive services from abroad that are subject to VAT under article 44 of the VAT Directive (for example, electronically supplied services).[858] No turnover threshold applies to supplies of those cross-border services. In some Member States (Belgium, France, Greece), small businesses must be registered for VAT, irrespective of whether their turnover remains below the "registration threshold".[859]

#### *8.1.2.7 Interim conclusions*

Giving the wrong answer to the question of whether or not a natural or legal person acts as a taxable person for VAT purposes, i.e. whether or not that person is engaged in economic activities, may have dramatic financial consequences because the tax authorities normally check a person's VAT liability

857 Approximately EUR 25,000.
858 Art. 283 of the VAT Directive.
859 W. van der Corput & F. Annacondia, *EU VAT Compass 2012/2013*, sec. 2.3 (IBFD 2013).

retrospectively over a period of several years and, if it exists, the VAT liability is a substantial percentage of the person's total gross proceeds. Where a person registers for VAT under the assumption that he is engaged in economic activities but the tax authorities (and the national courts) take a different position, that person will be liable for repayment of the amount of VAT that he has claimed as refundable input tax, especially where the initial output tax liability is nil or relatively low. On top of having to repay to the tax authorities the incorrectly claimed input tax, the person may incur a penalty for having fraudulently reclaimed tax. By contrast, where a person does not register for VAT under the assumption that he is not engaged in economic activities but the tax authorities take a different position, that person will be liable for payment of the VAT that he has not declared and remitted on the output transactions, especially where the initial input tax claim is nil or relatively low. On top of having to pay the unpaid tax, without having the possibility to recharge the tax to his customers, the person may incur a penalty for having committed tax fraud. To a certain extent, the VAT registration threshold should prevent unexpected VAT assessments in a large number of situations but it does not solve all problems since small businesses are required to register irrespective of their turnover if they supply cross-border services.

It is not possible to give a clear answer to the question when a person trading in virtual currency becomes a taxable person. The definition contained in the VAT Directive is very broad. The ECJ gives general guidance and recommends a case-by-case analysis. Thus, an individual case may be interpreted differently by tax authorities and courts. The virtual and informal character of the activities aggravates the existing characterization problems. Although, as shown in the sections above, some indicators of economic activity can be found, it is not possible to consider their existence to be an unequivocal sign that taxable activities are likely to occur. The issue of the unclear concept of taxable person implies lack of certainty in the EU VAT system. As an example of deviations from the prescriptions of the model tax system, it is further discussed in Chapter Nine.

### 8.1.3 Taxable transaction

#### *8.1.3.1 Supplies of goods and services*

Taxable transactions are defined in articles 14 to 30 of the VAT Directive and include: supplies of goods and services, intra-Community acquisitions and importation.[860] A supply of goods is defined as the transfer of the right to dispose of tangible property as owner.[861] The transfer does not have to take place in accordance with the procedures prescribed by the applicable national private law. It is sufficient that the transaction empowers the other party to actually dispose of the goods as if he were the owner of the property.[862] This view is in accordance with the purpose of the VAT Directive, which is designed to base the common system of VAT on a uniform definition of taxable transactions. This objective might be jeopardized if the preconditions for a supply of goods varied from one Member State to another, as do the conditions governing the transfer of ownership under private law.[863]

The supply of services is defined residually as any transaction which is not a supply of goods.[864] Under article 25 of the VAT Directive, the supply of services may include: assignments of intangible property, obligations to refrain from an act or to tolerate an act or situation, and performances of services in pursuance of an order made in the name of a public authority or in pursuance of the law. This list is not meant to be exhaustive. The characterization as goods or services is important in terms of the applicable rates, exemptions and place-of-supply rules. Moreover, services cannot be imported or subject to an intra-Community acquisition.

An important category of services are electronically supplied services (commonly referred to as "digital supplies" or "online services").[865] They are defined as services delivered over the Internet or an electronic network, the nature of which renders their supply essentially automated, involving minimum human intervention and impossible in the absence of information technology.[866] A non-exhaustive list of those services provided in the VAT Implementing Regulation includes: website hosting, distance maintenance of programmes, as well as supplies of software and other digitalized products (text, images, music, information and games).[867] The fact that the list is not exhaustive offers flexibility necessary to take into account future technological developments.

860 Since importation and intra-Community acquisitions involve goods, they are not discussed further due to their irrelevance to the exchange of virtual items and currencies. All transactions in virtual currencies and items are characterized as supplies of services for EU VAT purposes.

861 Art. 14(1) of the VAT Directive.

862 ECJ, 8 Feb. 1990, C-320/88, *Staatssecretaris van Financiën v Shipping and Forwarding Enterprise Safe BV*, para. 7.

863 Id., para. 8.

864 Art. 24 of the VAT Directive.

865 Sometimes the term "digital supplies" (or "digital services") is used to refer to telecommunications, broadcasting and electronic services. When this thesis refers to those three categories, it uses the term "TBE services".

866 Art. 7(1) of the VAT Implementing Regulation.

867 Art. 7(2) and Annex 1 of the VAT Implementing Regulation.

Whether the transfer of a standard computer program (for example, a game) constitutes a supply of goods or services depends on how it is executed. The channel of distribution decides about the characterization of a transaction for VAT purposes. The sale of a game on a physical carrier is a supply of goods, whereas downloading the same game is a supply of services.[868] The distinction between traditional goods and digital items (treated as services), both of which provide the same content, seems to contradict the principle of fiscal neutrality and equal treatment. However, in the view of the European Commission:[869]

> 'it is by no means clear that digital information services are the direct equivalent of traditional printed products – even where the content is similar, the additional functionality (e.g. search facilities, hyperlinks, archives) increasingly associated with electronic content produces a fundamentally different product.

In December 2011, the European Commission issued a communication on the future of VAT, in which it took a different approach:[870]

> 'Similar goods and services should be subject to the same VAT rate and progress in technology should be taken into account in this respect, so that the challenge of convergence between the on-line and the physical environment is addressed.'

Virtual currencies and items are intangible by nature and their transfers occur only via the Internet. The fact that some virtual items require a lot of effort by the user to be created (for example, *Second Life* objects programmed by him

868 This distinction is particularly relevant in the case of books: printed books may be subject to the reduced rate, whereas electronic books are standard rated.

869 European Commission, *Taxation and Customs Union, Frequently Asked Questions: How VAT Works*, available at http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/e-services/article_1610_en.htm#a7.

870 European Commission, *Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the Future of VAT: Towards a Simpler, More Robust and Efficient VAT System Tailored to The Single Market*, COM(2011) 851 final (6 Dec. 2011), para. 5.2.2. In response to the Commission's communication, the European Parliament adopted a resolution advocating the equalization of VAT treatment between books and e-books: "all books, newspapers and magazines regardless of format should be treated in exactly the same way, which means that downloadable and streamed books, newspapers and magazines should be subject to the same VAT treatment as books, newspapers and magazines on physical means of support". *See* European Parliament, Resolution 2011/2082(INI) of 13 Oct. 2011. In the case *K Oy* (C-219/13), the ECJ is requested to examine whether the application of a different VAT rate for printed books and books stored on other physical data storage systems is in line with the EU law. According to the opinion of the Advocate General, books stored on other physical data storage systems qualify as a specific and independent product group and it has to be examined from the point of view of customers in a particular country whether printed books and books stored on other physical data storage systems are competitors and similar to each other. At the time of the writing of this thesis (June 2014), the ECJ has not delivered its judgment yet.

or bitcoin mining) does not preclude their characterization as electronically supplied services. The definition of such services refers only to minimum human effort in the transfer of digital objects but in not their creation. As the transfer of all virtual items and currencies can easily occur with a few clicks, all transactions involving them are regarded as supplies of electronic services under the EU VAT system.[871]

### *8.1.3.2 Consideration*

To fall within the scope of VAT, the supply must be carried out for consideration. In *Hong Kong Trade Development Council* (C-89/81), the ECJ held that that a person who habitually provides services free of charge is not a taxable person at all. Such a person must be assimilated to a final consumer.[872]

The consideration is a subjective concept. It does not have to reflect the actual value of the supply or a value estimated according to objective criteria. Moreover, it must be capable of being expressed in money.[873]

There must be a direct link between the service provided and the consideration received.[874] A supply is taxable only if there is a legal relationship between the service provider and the recipient (a reciprocal performance).[875] However, VAT liability does not depend on the existence of an enforceable and binding obligation according to domestic law of a Member State. This would be contrary to the principle of VAT neutrality. Decisive is the mutual agreement, i.e. that the parties agree to exchange some items and not a valid legal relationship between them.[876]

It cannot be disputed that a bilateral legal relationship exists between the parties who exchange virtual items and currencies. The transaction is performed in order to obtain consideration from the other party. However, a link between the services provided and consideration received cannot be assumed in the case of bitcoin mining or objects found in virtual worlds (drops).

871 The question of whether exchanges of virtual currency into traditional currency can be classified as services for EU VAT purposes is currently pending before the ECJ. On 2 June 2014, a Swedish court asked the ECJ to clarify the VAT treatment of bitcoins. *See* Case C-264/14, *Skatteverket v. David Hedqvist*.

872 ECJ, 1 Apr. 1982, C-89/81, *Staatssecretaris van Financiën v. Hong Kong Trade Development Council*, para. 10.

873 ECJ, 5. Feb. 1981, C-154/80, *Staatssecretaris van Financiën v Association coopérative "Coöperatieve Aardappelenbewaarplaats GA"*, para. 13; ECJ, 16 Oct. 1997, C-258/95, *Julius Fillibeck Söhne GmbH & Co. KG v. Finanzamt Neustadt*, para. 13; ECJ, 23 Nov. 1988, C-230/87, *Naturally Yours Cosmetics Limited v. Commissioners of Customs and Excise*, para. 16.

874 ECJ, 8 Mar. 1988, C-102/86, *Apple and Pear Development Council v. Commissioners of Customs and Excise*, paras. 11 and 12; ECJ, 3 Mar. 1994, C-16/93, *R. J. Tolsma v Inspecteur der Omzetbelasting Leeuwarden*, para. 13.

875 ECJ, 6 Oct. 2009, C-267/08, *SPÖ Landesorganisation Kärnten*, para. 19 with further references.

876 ECJ, 17. Sep. 2002, C-498/99, *Town & County Factors Ltd v Commissioners of Customs & Excise*, para. 24.

Although it may appear that bitcoin miners perform a service (solving cryptographic algorithms to verify bitcoin transactions) for which they get paid in bitcoins, not every mining service is rewarded. As more and more miners compete for a limited supply of blocks to verify, they cannot be certain that they receive a reward for their mining efforts. Similarly, a MMORPG player cannot be sure that he will find virtual objects in the game. Thus, mining activities and drops are outside the scope of VAT.[877]

When virtual items are exchanged for real money, the consideration is easily identifiable. However, within a virtual world, items are exchanged for other items (or virtual currency). Sales of goods and services for bitcoins involve no monetary element either (i.e. no money in the legal sense is transferred). Both types of exchanges represent barter transactions. Every barter transaction consists of two separate transactions whose VAT treatment depends on whether they are performed between two taxable persons or whether there is a private person involved. In a B2B case, VAT applies to both transactions. In a B2C case, the B2C part is subject to VAT but the C2B part is not. The main problem presented by barter transactions is how to determine the value of the consideration. In *Empire Stores* (C-33/93), the ECJ held that consideration may consist in a provision of services and, in such a case, the value of consideration must correspond to the value which the recipient attributes to the services which he is seeking to obtain and to the amount which he is prepared to spend for that purpose. In *First National Bank of Chicago* (C-172/96), the ECJ observed that any technical difficulties which exist in determining the amount of consideration cannot by themselves justify the conclusion that no consideration exists.[878]

Although the majority of virtual transactions consists in a digital barter, the valuation problems identified while discussing the income tax consequences of virtual transactions are not equally relevant in the VAT context. It is not necessary to establish the objective value of an item since the consideration is a subjective concept. It is decisive what value is attributed to the transaction by the individual person.

Since VAT is a tax on private expenditure, the value that the consumer has to sacrifice (i.e. the value of the object disposed of by him) should be relevant. However, this theoretically correct result cannot be applied in practice, since the supplier must account for VAT. If the value determined by the customer was decisive, the taxable person would have to ask the other party about that value in order to calculate the VAT due, which would be rather impractical. Thus, the subjective value that the supplier attaches to the supply should be

877 The same view is expressed in HMRC, *Brief 09/14, supra* n. 44.

878 ECJ, 14 July 1998, C-172/96, *Commissioners of Customs & Excise v First National Bank of Chicago*, para. 31.

the basis of assessment.[879] In barter transactions between two taxable persons that have the full right to input VAT deduction the value of the consideration is irrelevant.

### *8.1.3.3 Unlawful activities*

Based on the wording of article 9(1) of the VAT Directive ("whatever the purpose or result of that activity"), the illegality or even immorality of certain activities should not play any role in a tax that aims to apply to private expenditure. However, certain illegal transactions fall outside the scope of VAT. It is necessary to examine whether the fact that trade in virtual items from some MMORPGs is forbidden by the world operator could have an impact on the VAT treatment of the transaction.

The VAT Directive does not explicitly mention unlawful activities. The ECJ has established rules for the VAT treatment of such activities on basis of the principle of neutrality. According to the settled ECJ case law, import and supplies of goods which are totally prohibited in the European Union are outside the VAT scope.[880] However, illegal supplies that may compete with lawful ones should be taxed according to the general rules.[881] If the corresponding lawful supplies are exempt, the unlawful supplies should be exempt too. Such treatment is in line with the principle of fiscal neutrality, which would be violated if unlawful supplies were treated more favourably than lawful ones.

Supplies of certain virtual items could be deemed unlawful since they are performed without the permission of the copyright holder. However, virtual items are not prohibited from entering economic channels due to their characteristics. They can be sold and marketed by the world operators or any other persons (with the creator's permission). A ban on marketing and selling activities does not exclude competition between the legal and illegal market. Thus, forbidden trade in virtual items cannot be removed from the scope of the VAT Directive.

Another question that must be discussed in connection with unlawful activities is whether VAT liability may exist in the case of stolen virtual objects. The ECJ shed more light on this issue in *Newman Shipping* (C-435/03).[882] It held that a theft of goods does not give rise to any financial counterpart for

879 B. Terra & J. Kajus, *A Guide to the Recast VAT Directive,* sec. 7.3.1.3 (2012), Online Books IBFD.

880 ECJ, 28 Feb. 1984, 294/82, *Senta Einberger v. Hauptzollamt Freiburg* (illegal import of drugs (morphine) into Germany), ECJ, 5 July 1988, 269/86, *W.J.R. Mol v. Inspecteur der Invoerrechten en Accijnzen* (sale of amphetamines).

881 ECJ, 2 Aug. 1993, C-111/92, *Wilfried Lange v. Finanzamt Fürstenfeldbruck*. Later ECJ case law follows the same line of argumentation.

882 ECJ, 14 July 2005, C-435/03, *British American Tobacco International Ltd, Newman Shipping & Agency Company NV v. Belgian State.*

the victim of the theft, and, following the reasoning in *Tolsma* (C-16/93), it cannot be considered a supply of goods for consideration.[883] The ECJ also observed that, as a result of the supply of goods, the recipient should be empowered to actually dispose of the property as if he were its owner. A theft of goods does not fulfill these criteria since it merely sets the thief as the possessor of the goods and does not empower him to dispose of the goods as if he were their owner.[884]

Digital items are characterized as services for VAT purposes. For services, the criterion of empowering the purchaser with the right to dispose over the received content as if he was its owner is not required (just as it is in the case of goods). A thief or other unlawful possessor of virtual items can transfer them in competition with legal transfers. Therefore, theft of virtual items meets the criteria of a supply of services; however, it is not taxable due to the lack of consideration.

### 8.1.4 Place of taxation

#### *8.1.4.1 Initial comments*

EU VAT rules are based on the concept of territoriality: only transactions taking place within the territory of the Member States are subject to VAT. The VAT Directive contains a number of rules that determine where transactions are deemed to occur (these provisions are commonly referred to as "place-of-supply rules"). Originally, many supplies of services were subject to VAT at origin, i.e. in the Member State where the service provider was established. This was a logical solution at the time when most services were provided domestically. However, due to the rapid increase in the volume of cross-border services, it was recognized that the origin–based approach distorted competition in favour of business activity in low-tax countries.[885] To increase the application of the destination principle, which is regarded as the conceptually ideal approach to taxing consumption, the European Union introduced a major amendment to the place-of-supply rules in 2008.[886] This reform, commonly referred to as the "VAT Package", phased in changes to the rules on the place of taxation of services between 2010 and 2015. Since 2010, the general rule for B2B services is that they take place where the customer has established his business (or has a fixed establishment if that establishment is the recipient

883 Id., at para. 32.
884 Id., at paras. 35-36.
885 Suppliers of electronic services choose to provide such services from Luxembourg to benefit from the lowest VAT rate of the European Union (15%). This will no longer be possible once the new rules become applicable (1 January 2015).
886 *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.

of the services), whereas B2C supplies still follow the origin principle.[887] There are, however, many exceptions to those general rules.[888] The last stage of the "VAT Package" will take effect on 1 January 2015. It will affect supplies of telecommunications, broadcasting and electronic (TBE) services by EU service providers to EU final consumers.[889] Such services will be deemed to be supplied where the non-taxable customer is established, has his permanent address or usually resides.

Since virtual currency is classified as electronically supplied services for VAT purposes, the following sections discuss the current and new place-of-supply rules applicable to this type of supplies.

*8.1.4.2 Rules until 1 January 2015*

Until 1 January 2015, the place of supply of cross-border electronic services depends on four factors:
- the status of the customer (taxable or non-taxable person);[890]
- the location of the customer;[891]
- the location of the supplier; and
- the place of effective use and enjoyment of the service.

Electronic services supplied to a taxable person (B2B supplies) are deemed to be performed at the place where the customer has established his business (or has a fixed establishment if that establishment is the recipient of the services).[892] Cross-border B2B supplies are subject to the reverse charge mechanism.[893] This means that the VAT liability is shifted to the customer, i.e. the supplier issues an invoice without VAT and the customer accounts for VAT on the supply in his VAT return.

Supplies of electronic services to non-taxable customers (B2C supplies) are deemed to be made where the service provider is established. However, there are two exceptions to this rule. First, electronic services supplied to customers located outside the European Union follow the destination principle and are

887 Arts. 44 and 45 of the VAT Directive.
888 For example, there are special rules for services related to immovable property, transport services, cultural, artistic, sporting and entertainment activities. *See* arts. 46 to 59b of the VAT Directive.
889 For a detailed description of the new rules, *see* A. Bal, EU VAT: New Rules on B2C Supplies of Digital Services from 2015, 54 Eur. Taxn. 7 (2014).
890 The question of how to determine the status of the customer is explained in section 8.1.4.3.2. *Status of the customer*.
891 The question of how to determine the status of the customer is explained in section 8.1.4.3.3. *Location of the customer*.
892 Art. 44 of the VAT Directive (the default place-of-supply rule for B2B services).
893 Art. 196 of the VAT Directive. The reverse charge mechanism does not apply if the recipient of the services is the customer's fixed establishment that is located in the same Member State as the supplier. In such circumstances, the supplier has to charge VAT.

outside the scope of EU VAT.[894] Second, electronic services supplied to EU customers by non-EU service providers take place in the Member State where the customer is located.[895] Non-EU suppliers of such services can register and account for VAT in a single Member State, using an electronic registration, declaration and payment system (the One Stop Shop scheme).[896] This procedure has been implemented to facilitate VAT compliance and avoid multiple registrations.

Finally, Member States may exercise the option and levy VAT where consumption actually occurs.[897] A "use and enjoyment" clause may be applied by Member States to electronic services supplied by EU suppliers to both private and business customers. It allows Member States to consider that services supplied within their territory or in third countries are supplied, respectively, outside the European Union or within their territory if this is where those services are effectively used and enjoyed. The use-and-enjoyment criterion is not uniformly applied across the European Union.

Therefore, until 31 December 2014, suppliers of virtual currency must pay careful attention to both the status and the location of their customers since both concepts are required for the correct determination of the place of taxation. Once it is established that the customer is a taxable person (in EU scenarios) or an entrepreneur (in non-EU scenarios), the supplier simply does charge VAT. If the customer is a non-taxable person resident outside the European Union, no EU VAT is charged either. All supplies of virtual currency by EU taxable persons to EU private individuals are taxed at origin. Taxation at origin means that the VAT legislation of the supplier's country governs the supply. Suppliers can apply their own familiar rules instead of being confronted with unfamiliar legislation of the customer's country. Finally, non-EU entrepreneurs who supply virtual currency to EU private individuals must register in a Member State of their choice and identify the location of their customers on a transaction-by-transaction basis since the supply is governed by the legislation of their customer's country.

#### *8.1.4.3 Rules from 1 January 2015*

*Initial comments*

As from 1 January 2015, the place of supply of TBE services to non-taxable persons (B2C supplies) is deemed to be the place where the customer is estab-

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894 Art. 59(k) of the VAT Directive.
895 Art. 58 of the VAT Directive.
896 For more information on the One Stop Shop scheme, *see* section 8.1.9. *Administrative obligations*.
897 Art. 59a of the VAT Directive. This provision will continue to apply after 1 January 2015.

lished, has a permanent address or usually resides.[898] The place-of-supply rules for B2B transactions will remain unchanged.

To provide a better understanding of the new rules and ensure uniformity in their application, the European Commission issued two sets of informal non-binding guidance: Explanatory Notes and Guide to the Mini One Stop Shop.[899] The Guide provides additional information on the registration process, submission of VAT returns, VAT remittance and record keeping, whereas the Explanatory Notes intend to clarify the practical application of the new place-of-supply rules, especially how to determine the status and location of the customer.

*Status of the customer*

Since all supplies of TBE services (both B2B and B2C transactions) will be deemed to be made at the location of the customer, the status of the customer will only be relevant to establish who has to remit VAT to the tax authorities. Cross-border B2B supplies are subject to the reverse charge mechanism and the recipient of such supplies is responsible for VAT remittance, whereas in a B2C situation the supplier will remit VAT under the One Stop Shop scheme.

Within the European Union, the supplier may regard his customer as a taxable person if the customer has communicated his VAT identification number to him and the supplier has checked its validity or if the customer has demonstrated that he is in the process of registering for VAT.[900] Once in receipt of a valid VAT identification number, the supplier will not have to deal with the VAT law of a foreign country, as the liability to remit VAT is shifted to the customer. The supplier will only have to report the service in his VAT return and recapitulative statement.

According to article 18(2) of the VAT Implementing Regulation, if no VAT identification number has been communicated, the supplier *may* regard his customer as a non-taxable person, irrespective of any information to the contrary. The purpose of this provision is to provide certainty for the supplier as to the status of the customer by disregarding information other than the VAT identification number. However, the use of "may" makes it optional for the supplier to use this provision. If the supplier does not know the VAT identification number of the customer but has other evidence to substantiate his status as a taxable person, the supplier may issue an invoice without VAT and apply the reverse charge mechanism. In such a scenario, he assumes the risk for the incorrect status determination and will be held liable for VAT payment if his determination turns out to be wrong.

898 Art. 58 of the VAT Directive (as applicable from 1 January 2015).

899 European Commission, *Explanatory Notes on the EU VAT Changes to the Place of Supply of Telecommunications, Broadcasting and Electronic Services That Enter into Force in 2015* (3 April 2014); and *Guide to the VAT Mini One Stop Shop* (23 Oct. 2013).

900 Art. 18(1) of the VAT Implementing Regulation.

In non-EU scenarios, the status of the customer is not relevant. Since all TBE services supplied to non-EU customers are generally deemed to take place at destination, they are outside the scope of EU VAT.

*Location of the customer*
As from 1 January 2015, EU suppliers of B2C TBE services have to determine in which Member State their non-taxable customers are established, have their permanent address or usually reside.[901] The VAT Implementing Regulation provides guidance on how to interpret those concepts.

A permanent address of a natural person is the address entered in the population or similar register, or the address indicated by that person to the relevant tax authorities, unless there is evidence that this address does not reflect reality.[902] The place where a natural person usually resides is the place where that natural person usually lives as a result of personal and occupational ties. Where the occupational ties are in a country different from that of the personal ties, or where no occupational ties exist, the place of usual residence shall be determined by personal ties which show close links between the natural person and a place where he is living.[903] If a non-taxable person is established in more than one country or has his permanent address in one country and his usual residence in another, priority must be given to the place where he usually resides, unless there is evidence that the service is used at his permanent address.[904]

Suppliers of electronic services will have difficulty identifying and verifying the customer's permanent address or usual residence as any registers containing taxpayers' addresses are only available to the public authorities and the fact where a person has personal and occupational ties is not easily recognizable when a transaction takes place. The VAT Implementing Regulation establishes a number of rebuttable presumptions that should assist in identifying the customer's location. The rebuttable presumptions are as follows:

- If for the provision of TBE services the physical presence of the recipient is required (for example, a telephone box, a Wi-Fi hot spot or an Internet café), such services will be taxable at the location where the recipient effectively uses and enjoys them.[905]
- If TBE services are provided on board a ship, aircraft or train during an intra-Community passenger transport operation, the customer is presumed

901 The term "established" refers to non-registered legal persons and is not further discussed here. The expressions "permanent address" and "usual residence" to non-taxable natural persons.
902 Art. 12 of the VAT Implementing Regulation.
903 Art. 13 of the VAT Implementing Regulation.
904 Art. 24 of the VAT Implementing Regulation.
905 Art. 24a(1) of the VAT Implementing Regulation.

to be resident in the Member State of departure of the passenger transport.[906]

- If TBE services are provided to a customer through a fixed land line connected with a residential building, the customer is presumed to be located at the place where the fixed land line is located.[907]
- For services supplied via mobile networks, the customer is presumed to be established in the country identified by the mobile country code of the SIM card used for receiving such services.[908]
- For TBE services consisting of the transmission of signals for which a device or viewing card is needed, the customer is presumed to be located at the place where the device is installed or, if that place is not known, the place to which the viewing card is sent with the purpose of being used there.[909]

The service provider can rebut the above-mentioned presumptions on the basis of three items of non-contradictory evidence indicating that the customer is resident elsewhere.[910] Tax authorities may rebut the presumptions if there are indications of misuse or abuse by the supplier,[911] for example, if a supplier adopts a practice that would see the place of supply incorrectly determined in relation to a non-negligible proportion of his customers.[912]

If none of the rebuttable presumptions is applicable, it is assumed that the customer is established at the place identified on the basis of two of the following items of non-contradictory evidence (the "evidence rule"):[913]

- customer details, such as the customer' s billing address;
- the customer's Internet protocol (IP) address or any method of geolocation;
- bank details, such as the place where the bank account used for payment is and the billing address of the customer held by that bank;
- the mobile country code (MCC) of the international mobile subscriber identity (IMSI) stored on the subscriber identity module (SIM) card used by the customer;
- the location of the residential fixed land line through which the service is supplied to the customer; and
- other commercially relevant information obtained by the supplier.

The reference to "other commercially relevant information" takes into account that taxable persons use different business models and allows for other items of information, not specifically included in the list, to be used as evidence for

906 Art. 24a(2) of the VAT Implementing Regulation.
907 Art. 24b(a) of the VAT Implementing Regulation.
908 Art. 24b(b) of the VAT Implementing Regulation.
909 Art. 24b(c) of the VAT Implementing Regulation.
910 Art. 24d(1) of the VAT Implementing Regulation.
911 Art. 24d(2) of the VAT Implementing Regulation.
912 *Explanatory Notes*, *supra* n. 899, at sec. 8.4.2.
913 Arts. 24b(d) and 24f of the VAT Implementing Regulation.

the identification of the place where the customer is located. The supplier must evaluate the reliability of other items of information and be able to justify why they are relevant to him.[914]

The items of evidence used to identify the location of the customer must be different and should not duplicate each other. For example, the fact that the customer gives his bank details and those details are confirmed by a payment service provider is considered one piece of evidence.[915]

If each piece of evidence points to a different country, the supplier must decide which item of evidence is more reliable in determining the customer's location. Priority should be given to the country that best ensures taxation at the place of actual consumption.[916]

The supplier must verify the evidence items collected by normal commercial security measures, such as those relating to identity or payment checks.[917] Since the correct determination of the place of supply remains with the supplier, verification by third parties (for example, payment service providers) does not relieve the supplier of his responsibility in situations of abuse or misuse.[918]

Trade in virtual currencies involves a large number of relatively low-value transactions. In view of this fact, it may be impractical for suppliers of virtual currency to establish the location of the customer on a transaction-by-transaction basis, especially if they have to apply the evidence rule. The evidence items suggested by the VAT Implementing Regulation may not available for traders with low turnover who do not apply sophisticated verification mechanisms. Since too complex compliance requirements may compromise the principle of simplicity and efficiency, the difficulty in identifying the customer's location could be an example of how the EU VAT deviates from the characteristics of the model tax system. This issue and potential solutions to remedy it are discussed in Chapter Nine.

### 8.1.5 Chargeable event and tax liability

It is important to distinguish between the concepts "tax chargeable" and "tax due". VAT becomes chargeable when tax authorities become entitled to claim it from the person liable to pay it although the time of payment may be deferred.[919] VAT becomes due when it must be remitted to the tax authorities.

914 *Explanatory Notes*, *supra* n. 899, at sec. 9.5.1.
915 Id., at sec. 9.5.5.
916 Id., at sec. 9.5.6.
917 Art. 23 VAT of the Implementing Regulation.
918 *Explanatory Notes*, *supra* n. 899, at sec. 9.5.9.
919 Art. 62 (2) of the VAT Directive.

VAT liability arises as soon as an item is supplied by electronic means.[920] However, it does not have to be settled immediately but by the deadline provided by the domestic legislation. This deadline usually coincides with the deadline for the submission of the VAT return.

Under the general rules, VAT must be remitted by the taxable person carrying out the supply.[921] However, to simplify the collection process, the reverse charge system has been introduced for certain B2B supplies. It means that the obligation to remit VAT is shifted to the recipient of the supply, provided that he is a taxable person. If the recipient uses the services or goods for carrying out taxable transactions, the amount of tax to be paid is immediately deductible, so there is no actual payment to the tax authorities. The main benefit of the reverse charge mechanism is that foreign suppliers do not have to register and account for VAT in the customer's country. Apart from the simplification objective, the reverse charge is also used as a means of combating VAT fraud. The reverse charge rule applies to all supplies of electronic services to taxable persons.

### 8.1.6 Exemptions

The term "exempt supplies" describes supplies that do not bear output VAT: the supplier does not have to collect and remit any tax in respect of the supply and the recipient is not entitled to any input tax deduction. However, this terminology is misleading: from the point of view of taxable persons, exempt supplies are actually "taxable" and taxable supplies are actually "exempt". In the case of a taxable supply, the taxable person can recover input VAT. As there is no recovery of input tax embedded in the price of exempt supplies, the cost of the tax included in the price must be borne by businesses that acquires the exempt supply and can only be recovered if the tax is passed onto consumers in the price. Both taxable and exempt supplies are taxed from the perspective of consumers, either with an explicit tax levied on the supply or an embedded tax included in the supply cost.[922]

There is an extensive use of VAT exemptions across the European Union.[923] Member States exempt some categories of goods and services considered as essential for social reasons: healthcare, education and supplies by charities. In addition, they also use exemptions for practical reasons (for example, in the case of financial and insurance services due to the difficulties in assessing the taxable amount). Exemptions beyond these core items cover a wide variety of sectors, such as culture, legal aid, passenger transport, public cemeteries,

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920 Art. 63 of the VAT Directive.
921 Art. 193 of the VAT Directive.
922 De la Feria & Krever, *supra* n. 770, at sec. 1.02.
923 Arts. 131-166 of the VAT Directive.

waste and recyclable material, water supply, precious metals and certain agricultural inputs.

Article 135(1)(e) of the VAT Directive provides for an exemption from VAT for:

> 'transactions, including negotiation, concerning currency, bank notes and coins used as legal tender, with the exception of collectors' items, that is to say, gold, silver or other metal coins or bank notes which are not normally used as legal tender or coins of numismatic interest.'

The wording of the provision clearly indicates that the term "currency" refers to money used as legal tender. As shown in Chapter Three, although virtual community-related and universal currencies share a lot of characteristics with traditional currencies, they cannot be regarded as such but they are properly classified as digital commodities. For VAT purposes, transactions involving virtual currencies are characterized as supplies of electronic services and not as financial or payment transactions. Thus, the exemption of article 135(1)(e) of the VAT Directive cannot be applied.[924] None of other exemptions seems to cover transactions in virtual items either.[925]

### 8.1.7 Taxable amount

VAT liability is calculated by applying the VAT rates to the taxable amount. The taxable amount includes everything that constitutes consideration obtained or to be obtained for the supply from the supplier or a third party.[926]

Member States are bound by the common rules regarding VAT rates. These rules provide that supplies of goods and services are generally subject to a standard rate of at least 15%. There are differences in the standard rates between the Member States, with rates ranging from 15% (Luxembourg) to 27% (Hungary).

Reduced rates of no less than 5% may be applied to goods and services enumerated in Annex III of the VAT Directive. They usually apply to basic essentials, such as medical and hospital care, food and water supplies, and to activities that are considered socially desirable. One of the reasons for the

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924 The Norwegian Directorate of Taxation and the Estonian Tax and Customs Board are of the same opinion (*see supra* ns. 43 and 46). A different view is expressed in HMRC, *Brief 09/14, supra* n. 44.

925 The question of whether transactions between virtual and traditional currencies can be classified as services for EU VAT purposes is currently pending before the ECJ. On 2 June 2014, a Swedish court asked the ECJ to clarify the VAT treatment of bitcoins. *See* Case C-264/14, *Skatteverket v. David Hedqvist*.

926 Art. 73 of the VAT Directive. A list of the items included into and excluded from the taxable amount is provided in arts. 78 and 79 of the VAT Directive.

introduction of a differentiated rate structure is the promotion of equity. It is considered desirable to alleviate the tax on goods and services that form a larger share of expenditure of the poorest households. Such a policy is partly based on the assumption that consumption taxes have a regressive impact on the income distribution. However, the effectiveness of the reduced VAT rates to achieve distributional objectives is questionable in that the wealthier members of the population also benefit from them. Moreover, rate differentiation increases administrative and compliance costs, legal uncertainty and opportunities for fraud through deliberate misclassification of items.[927]

Article 98(2) and Annex III of the VAT Directive allow applying the reduced rate to supplies of services by writers (i.e. the transfer of copyright). The developers of computer programs (for example, *Second Life* items) could fall into that category as a computer program is a literary work protected by copyright.[928] However, the VAT Directive clearly excludes the application of the reduced rates to electronically supplied services. The European Commission has taken the position that information supplied online is not equivalent to information supplied as part of tangible products since the former offer additional features.[929] Although the content purchased is the same, the supply of goods in a digital format should not bear the same rate as the sale of similar tangible goods.

### 8.1.8 Tax deduction

The right to deduct input VAT is what mainly distinguishes an all-stage consumption tax from a single stage retail sales tax. Under the EU VAT system, VAT is charged on all transactions, irrespective of the status of the customer. However, taxable persons who perform taxable transactions are relieved from the tax burden by deducting, from their VAT liability, VAT invoiced to them by other taxable persons.[930] In its numerous judgments, the ECJ stressed that the right to deduct is a fundamental part of the VAT scheme and may not be limited.[931] The right to deduct input VAT arises as soon as the deductible

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

928 Art. 1 of *Directive 2009/24/EC of the European Parliament and of the Council of 23 April 2009 on the Legal Protection of Computer Programs*, OJ L 111/16.

929 European Commission, *Taxation and Customs Union, Frequently Asked Questions: How VAT Works*, available at http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/e-services/article_1610_en.htm#a7.

930 Arts. 167-192 of the VAT Directive.

931 For example, ECJ, 1 Mar. 2012, C-280/10, *Kopalnia Odkrywkowa Polski Trawertyn P. Granatowicz, M. W¹siewicz spółka jawna v. Dyrektor Izby Skarbowej w Poznaniu*, para. 40.

tax becomes chargeable.[932] To exercise it, the taxable person must hold an invoice drawn up in accordance with the applicable rules.[933]

Taxable persons who incur VAT in connection with their business activities in a Member State in which they do not make taxable supplies of goods or services are also entitled to deduct the VAT charged in that Member State. This "deduction" occurs by means of a refund of VAT from the Member State in which the VAT was paid. EU taxable persons may use an electronic procedure by submitting a refund application to the tax authorities in their country of residence.[934] Third-country suppliers have to contact the Member State in which input VAT was incurred.[935] They must provide the competent tax authorities with a certificate of entrepreneurial status and original invoices.

### 8.1.9 Administrative obligations

#### *8.1.9.1 Registration*

Taxable persons face numerous administrative obligations. First, they must register their economic activity with the competent tax authorities. Under article 213 of the VAT Directive, every taxable person shall state when his economic activity commences, changes or ceases. Detailed rules on the registration of taxable persons are laid down in the domestic legislation of the Member States. In most countries, registration thresholds are used to relieve taxpayers with low turnover ("small enterprises")[936] from levying and collecting tax.[937] If the turnover is equal to, or higher than, the threshold, VAT registration is required. Taxable persons with a turnover below the threshold can opt for registration. The registration thresholds vary significantly among Member States. They can be as low as EUR 1,450 (the Netherlands) or reach EUR 93,300 (the United Kingdom).[938] However, it is important to keep in mind that small enterprises have to register irrespective their turnover if they render services to taxable persons established in other Member States and those services are

932 Art. 167 of the VAT Directive.
933 Art. 178(a) of the VAT Directive.
934 *Council Directive 2008/9/EC of 12 February 2008 Laying Down Detailed Rules for the Refund of Value Added Tax, Provided for in Directive 2006/112/EC, to Taxable Persons Not Established in The Member State of Refund but Established in Another Member State*, OJ L 44/23 of 20 Feb. 2008.
935 *Thirteenth Council Directive 86/560/EEC of 17 November 1986 on the Harmonization of the Laws of the Member States relating to Turnover Taxes – Arrangements for the Refund of Value Added tax to Taxable Persons Not Established in Community Territory*, OJ L 326 of 21 Nov. 1986.
936 Arts. 281-292 of the VAT Directive.
937 Some countries use only collection thresholds: all taxable persons are required to register for VAT, but those with supplies below the threshold are relieved from collecting the tax.
938 For an overview of the registration thresholds in Europe, *see* F. Annacondia & W. van der Corput, *VAT Registration Thresholds in Europe*, 24 Intl. VAT Mon. 6 (2013).

deemed to be supplied in the customer's country or if they receive services from abroad that are subject to VAT under article 44 of the VAT Directive. No monetary threshold applies to supplies of those cross-border services. Supplies of virtual currency fall into that category, and this means that persons selling virtual currency have to register no matter how low their turnover from such transactions is. A failure to observe the obligation to register may result in penalties. According to the ECJ, those penalties must not go further than is necessary to attain the objectives of the correct tax levying, tax collection and fraud prevention. In order to assess whether the penalty at issue is consistent with the principle of proportionality, the nature and the degree of seriousness of the infringement which that penalty seeks to sanction must be taken into account.[939] As the registration obligation constitutes only a formal requirement, the penalty must not seek to ensure recovery of the tax from the party liable for it.[940]

#### *8.1.9.2 One Stop Shop scheme*

Electronic services supplied by non-EU service providers to EU final consumers are deemed to take place where the non-taxable customer is established, has his permanent address or usually resides.

In order to avoid that, for the purpose of having to account for VAT on B2C electronic services in a maximum of 28 Member States, non-EU suppliers must be registered in all of those Member States, the One Stop Shop scheme (OSS) was introduced on 1 July 2003. Under this scheme, the non-EU supplier can register and account for VAT in a single Member State, albeit at the VAT rate of the customer's Member State. The Member State of registration forwards the amounts of VAT to the respective Member State of consumption. The One Stop Shop Scheme cannot be used by non-EU suppliers that are already registered in the European Union (for example, because they receive services that are effectively used and enjoyed in a Member State or perform intra-Community supplies of goods).[941]

In order to facilitate compliance with the new place-of-supply rules that will enter into force on 1 January 2015, EU suppliers of electronic services to EU final consumers will have the option to account for VAT under a similar arrangement (the Mini One Stop Shop scheme). They will be able to register in the Member State of establishment, account for and remit VAT there. The Mini One Stop Shop regime is optional; however, a taxable person that chooses to use the scheme must apply it in all relevant Member States. The scheme cannot be applied to supplies of electronic services in the Member State where

939 ECJ, 19 July 2012, Case C-263/11, *Ainārs Rēdlihs v Valsts ieņēmumu dienests*.
940 ECJ, 21 Oct. 2010, C-385/09, *Nidera Handelscompagnie BV v Valstybinë mokesèiø inspekcija prie Lietuvos Respublikos finansø ministerijos*, para. 50.
941 Art. 358a of the VAT Directive.

the taxable person is established; such supplies must be declared in the domestic VAT return.

The records that should be kept by the person applying the Mini One Stop Shop scheme are laid down in article 63c of the VAT Implementing Regulation. They include: general information, such as the Member State of consumption of the supply, the type of supply, the date of the supply and the VAT payable, but also more specific information, such as information used to determine the place where the customer is established, has his permanent address or usually resides. The records must be kept for ten years from the end of the year in which the transaction took place, regardless of whether or not the supplier has stopped using the scheme. They have to be made electronically available on request to the Member State of identification or any Member State of consumption without delay. A failure to make these records available will result in exclusion from the scheme.[942]

A successful example of the application of the One Stop Shop arrangement is the case of *Second Life*.[943] All EU residents are charged VAT on their transactions (purchase of virtual land and currency) with the world operator, Linden Lab. When opening an account, users must mention their country of residence. Linden Lab has a risk detection system that may identify discrepancies between the actual IP address and the declared country. If a discrepancy is detected, the account is flagged for review or even suspended. Taxable persons have the possibility to enter their VAT identification number to avoid being charged VAT. However, Linden Lab neither acts as a tax collector nor has incorporated a VAT system within its online environment: transactions between individual residents in Linden Dollars remain tax free.

#### *8.1.9.3 Other compliance obligations*

Taxable persons must issue VAT invoices to their customers. The detailed rules on the invoice content and form are laid down in the VAT Directive.[944] For a long time, the invoicing rules in the European Union were far from uniform, which caused administrative burdens and considerable uncertainty for companies engaged in cross-border activity. This lack of uniformity led to the adaptation of the Invoicing Directive[945] on 13 July 2010. This Directive, which entered into force on 1 January 2013, simplified and harmonized the invoicing rules, and implemented the freedom of choice regarding the invoicing method:

942 *Guide to the VAT Mini One Stop Shop*, *supra* n. 899, at part 4.
943 http://secondlife.com/corporate/vat.php
944 Arts. 220-249 of the VAT Directive.
945 *Council Directive 2010/45/EU amending Directive 2006/112/EC on the Common System of Value Added Tax as regards the Rules on Invoicing*, OJ L 189/1 of 22 July 2010. For a description of the invoicing rules applicable as from 1 January 2013, *see* A. Bal, Recent EU VAT Changes – The Invoicing Directive, 52 Eur. Taxn. 9 (2012).

paper and electronic invoices are now treated equally.[946] Suppliers may use any invoicing method provided that it ensures the authenticity of the origin and the integrity of the invoice content. Invoicing is governed by the national legislation of the Member State in which the supply of goods or services is deemed to be made. The exception to that rule, i.e. the requirement that the invoices must be drawn up in accordance with the rules applicable in the service provider' s Member States, is limited to situations in which the customer must account for VAT under the reverse charge mechanism on the value of the B2B services received from abroad.[947]

Taxable persons must file VAT returns and remit VAT within the prescribed deadlines.[948] Taxable persons engaged in the provision of cross-border services to other EU taxable persons must additionally submit recapitulative statements (EU sales lists).[949] EU sales lists show the details of all service recipients and the value of supplies made to them during the reporting period.

As shown above, the status of taxable person is associated with extensive compliance obligations. A person that incorrectly assumes the status of a non-taxable person may face serious financial consequences and liability issues. For that reason, it is worth highlighting again the importance of the correct understanding of the concept of taxable person. The clarity and precision of this term is crucial to the correct functioning of the EU VAT system.

### 8.1.10 Conclusions

Section 8.1. has described EU VAT rules applicable to trade in virtual currencies. Supplies of virtual currency fall within the scope of EU VAT if they are performed by taxable persons acting as such. Taxable person is anyone who performs economic activities. According to the settled ECJ case law, the terms "taxable person" and "economic activities" should be objective in character. However, the analysis in this chapter showed that they are vague and give rise to diverging interpretations. The determination of when a person may qualify as a taxable person requires a complex case-by-case analysis, the outcome of which depends on the subjective perceptions of the examiners. The hobby component of trade in community-related currency aggravates the characterization issues.

Exchanges of virtual items and currencies are considered to be electronically supplied services since they involve transfers of data that occur via the Internet

946 Although paper and electronic invoices shall be treated equally, one important difference remains between those two types: the use of electronic invoicing should be accepted by customers. The acceptance may also occur by tacit agreement, for instance by processing or payment of the received e-invoice (art. 232 of the VAT Directive).

947 Art. 219a of the VAT Directive.

948 Arts. 250-261 of the VAT Directive.

949 Arts. 262-271 of the VAT Directive.

with minimum human intervention. Both lawful and unlawful supplies are taxed (i.e. not exempt) and subject to the standard rate. The EU VAT law does not require establishing the objective value of the consideration which constitutes the taxable amount. The subjective value that the taxable person attributes to the item disposed of is used as the taxable amount.

Under the place-of-supply rules, applicable as from 1 January 2015, all supplies of electronic services will follow the destination principle. In B2C scenarios, suppliers will be required to identify and verify the customer's location in order to apply the correct VAT rate. This may be a difficult task when services are provided at a distance, payment intermediaries are involved and no physical shipments take place.

Taxable persons are faced with numerous compliance obligations (registration, issue of invoices, submission of VAT returns and EU sales lists). Persons performing cross-border supplies of virtual currency have to register irrespective of their turnover. They cannot benefit from the exemption for small enterprises. Non-EU entrepreneurs (and as from 1 January 2015 also EU taxable persons) supplying virtual currency to EU private individuals have the option to register and account for VAT under the One Stop Shop scheme.

Based on the description of the EU VAT system, it can be concluded that some of its elements could deviate from the prescriptions of the model indirect tax system. Those issues are:
- the concept of taxable person lacking clarity;
- complexity and high compliance burden regarding the application of the destination principle; and
- the existence of voluntary compliance mechanisms, such as the One Stop Shop scheme.

Chapter Nine discusses those issues in more detail and proposes solutions to remedy them.

## 8.2 The United States

### 8.2.1 Initial comments

The United States is the only OECD member country that does not apply a nationwide federal consumption tax. Instead, almost every state levies its own sales tax. Although in their design state sales taxes follow a similar pattern, their rates and scope vary considerably. The following sections will focus on the common elements of these taxes but also highlight some deviations.

Sales taxes are also frequently imposed by local jurisdictions (counties, cities and districts). About 7,500 local governments levy local sales tax as a supplement to the state sales tax. Local sales taxes are commonly administered by the state and collected together with the state sales tax. However, they are frequently subject to different rules with regard to the tax base and exemptions and this highly complicates tax compliance.[950]

State sales taxes were introduced in the 1930s to compensate for the effects of the Great Depression on state finances. In view of declining revenue from income and property taxes, coupled with the increased demand for social services, state legislators saw the sales tax with its broad coverage and relatively simple compliance as the solution to their financial needs. Although intended as a temporary measure, sales taxes have turned out to be enduring in nature.[951] Currently 45 states and the District Columbia have sales taxes,[952] and these taxes contribute to about 30% of the states' tax revenue.[953]

## 8.2.2 State versus federal taxing rights

### *8.2.2.1 Due Process and Commerce Clause*

The US Constitution allows the states enormous latitude in taxation. It explicitly prohibits import and export duties, but beyond that it is largely silent on the taxing powers of the states. Constitutional restraints on the nature and scope of state taxation have resulted from judicial interpretations of two broad constitutional provisions: the Due Process Clause and the Commerce Clause.

The Due Process Clause relates to the fairness of the tax burden.[954] Due process can be procedural, which is concerned with how the government acts (administrative fairness), or substantive, which is concerned with whether or not it has the right to act.[955] With respect to sales and use tax, due process refers to links and contacts, both qualitative and quantitative, between the state and the person over which the state attempts to assert jurisdiction. The Supreme Court has provided two tests for the due process. In its view, under the Due Process Clause, state taxation requires:[956]

- a minimal connection (nexus) between the interstate activities and the taxing state; and

950 Brederode, *Introduction to the US State Sales and Use Taxes*, *supra* n. 771, at sec. 10.
951 Id., at sec. 1.
952 Sales taxes are not levied in: Alaska, Delaware, Montana, New Hampshire and Oregon.
953 R. v. Brederode, *The Harmonization of Sales and Use Taxes in the United States*, 18 Intl. VAT Mon. 6, sec. 1 (2007).
954 The Fifth and Fourteenth Amendments to the US Constitution contain a due process clause. The 14th Amendment states: "[Nor] shall any State deprive any person of life, liberty, or property, without due process of law". The 5th Amendment reads: "[N]or shall any person … be deprived of life, liberty, or property, without due process of law".
955 B.M. Nelson et al., *Sales and Use Tax Answer Book*, sec. 2:1 (CCH 2013).
956 *Exxon Corp. v. Wisconsin*, 447 US 207, 219-20 (1980).

- a rational relationship between the income attributed to the state and the interstate values of the enterprise.

To satisfy the due process test, the taxpayer does not have to be physically present in the state. It is sufficient if the taxpayer's commercial efforts are "purposefully directed" towards the state's residents.[957]

The Commerce Clause reserves to Congress the power to regulate international and interstate commerce.[958] Historically, the Commerce Clause restrictions on state and local taxation were ambiguous or even contradictory.[959] In *Complete Auto Transit* (1977), the Supreme Court provided a four-element test to determine whether or not a state tax on interstate commerce is constitutional. A tax that meets this test must:

- apply to an activity with a substantial nexus with the taxing state;
- be fairly apportioned;
- not discriminate against interstate commerce; and
- be related to the services provided by the state.[960]

The first prong is by far the most important component of the *Complete Auto* test. It prevents states from imposing sales or use tax compliance obligations on remote suppliers. The second prong (fair apportionment) ensures that multistate economic activity is not subject to taxation in two different states. The third element is satisfied as long as the tax rate does not exceed that which would apply to an intrastate sale. The fourth prong is closely connected to the first element of the test. Additionally, it requires the measure of the tax be reasonably related to the extent of the taxpayer's contact with the state. The Supreme Court has repeatedly interpreted this fourth prong as being met

957 *Quill Corp. v. North Dakota*, 504 US 298, 305 (1992).

958 The Commerce Clause reads: "The Congress shall have the power … to regulate commerce with foreign Nations, and among the several States, and with the Indian Tribes". Congress made use of its power to regulate interstate commerce by enacting the Internet Tax Freedom Act (ITFA) in 1998. The Act was enacted for a limited period of three years and was extended later several times, most recently until 1 November 2014. The Act forbids any tax on the Internet access and any multiple or discriminatory taxes on electronic commerce (such as a bit or bandwidth tax). However, it does not exempt from taxation sales made via the Internet.

959 For more information on the historical developments, *see* W. Hellerstein, *State Taxation of Interstate Business: Perspectives on Two Centuries of Constitutional Adjudication*, 41 Tax L., p. 37 (1987); J. Hellerstein, *State Taxation under the Commerce Clause: An Historical Perspective*, 29 Vand. L. Rev.. p. 335 (1976).

960 *Complete Auto Transit Inc. v. Brady*, 430 US 274 (1977). The taxpayer (a Michigan corporation) transported motor vehicles to Jackson, Mississippi, and handed them over to Mississippi dealers. Mississippi imposed a tax on "the privilege of doing business" in the state. The taxpayer argued that the transportation was a part of an interstate movement and the tax was unconstitutional as it applied to operations in interstate commerce. The Supreme Court ruled that a "privilege tax" can be applied to an out-of-state corporation's activities in the state without violating the Commerce Clause.

when a tax is measured as a percentage of some proxy for the value of the taxpayer's economic activity occurring within the state. As long as this is the case, the Supreme Court has declined to inquire into the appropriate tax rate, ruling that determinations about the appropriate levels of taxation must be made by the political process.[961]

Both the Due Process and the Commerce Clause serve as protection against states' aggressive taxing policy. However, their purpose is different: the former is concerned with the circumstances and procedures under which a jurisdiction can impose tax, while the latter – with the impact of a tax upon interstate commerce.[962]

#### *8.2.2.2 Landmark judgments*

Two judgments are of fundamental importance in interpreting the Due Process and Commerce Clause limitations on state taxation: *National Bellas Hess* (1967)[963] and *Quill* (1992).[964]

National Bellas Hess was a Missouri mail-order seller whose only contacts with the state of Illinois were through mail and commercial carriers. It did not have any property, employees or agents there. Customers sent their orders to Belles Hess's Missouri facility, and the goods were shipped to them either by mail or by common carrier. The tax authorities of Illinois argued that Bellas Hess was regularly and continuously exploiting the consumer market in Illinois and this should give rise to sufficient nexus in that state.

The Supreme Court found that the Illinois tax collection obligation violated both the Due Process and the Commerce Clause. It held that remote sellers can be required to collect tax only if they have a physical presence in the state. The reason for the restriction on the taxing power of the states was that, in the Court's view, the states' exercise of fiscal sovereignty had produced a sales tax system of such complexity that it was necessary to restrict the states' taxing powers by the physical presence test. The Supreme Court ruled that:

> 'the many variations in rates of tax, in allowable exemptions, and in administrative and record-keeping requirements could entangle [the taxpayer]'s interstate business in a virtual welter of complicated obligations to local jurisdictions.'

Quill, a Delaware corporation, sold office equipment to North Dakota customers by soliciting sales through catalogues, flyers, advertisements in periodicals and telephone calls. It did not have any property, employees or

961 D. Gamage & D.J. Heckman, *A Better Way forward for State Taxation of E-commerce*, 92 B.U.L. Rev., p. 493 et seq. (2012).
962 Nelson et al., *supra* n. 955, at sec. 2:5.
963 *National Bellas Hess v. Illinois*, 386 US 753 (1967).
964 *Quill Corp. v. North Dakota*, 504 US 298 (1992).

agents in North Dakota. The goods were shipped to North Dakota from out-of-state locations either by email or by common carrier. The question was whether there was a sufficient nexus to warrant taxation in North Dakota.

In the *Quill* judgment, the Supreme Court distinguished between the Due Process nexus (minimum contacts) and the Commerce Clause nexus (substantial presence). As these two tests were not identical, it was possible that a taxpayer's activities could satisfy one and fail the other:

> 'The State contends that the nexus requirements imposed by the Due Process and Commerce Clauses are equivalent and that if, as we concluded above, a mail order house that lacks a physical presence in the taxing State nonetheless satisfies the due process "minimum contacts" test, then that corporation also meets the Commerce Clause "substantial nexus" test. We disagree. Despite the similarity in phrasing, the nexus requirements of the Due Process and Commerce Clauses are not identical. The two standards are animated by different constitutional concerns and policies.'

The Supreme Court agreed that Quill's exploitation of the North Dakota market satisfied the Due Process test but not the nexus under the Commerce Clause. As the taxpayer purposely directed its activities towards North Dakota residents, its "economic presence" (solicitation of business) was sufficient to create some minimum connection with the state. However, the taxpayer lacked the substantial nexus (physical presence), which is created by, for example, employees, independent contractors or the ownership or leasing of property in a state.[965]

The physical presence test was justified based on *stare decisis*[966] and the concern that allowing states to impose compliance obligations on remote sellers could burden interstate commerce by entangling remote sellers in a "'virtual welter of complicated obligations' imposed by the "nation's 6,000-plus taxing jurisdictions":[967]

> 'North Dakota's use tax illustrates well how a state tax might unduly burden interstate commerce. On its face, North Dakota law imposes a collection duty on every vendor who advertises in the State three times in a single year. Thus, absent

965 It is not clear how much physical presence will create the necessary substantial nexus to satisfy the Commerce Clause. The Supreme Court stated that "the slightest presence" is not sufficient (*National Geographic Society v. California Board of Equalization*, 430 US 551 (1997)). In *Quill*, the Court held that the Quill's ownership of some floppy disks in North Dakota did not create substantial nexus. Moreover, the Court made it clear in *Miller Bros Co. v. State of Maryland*, 347 US 340 (1954) that advertisements in newspapers and on the radio did not meet the necessary nexus requirement.

966 The invocation of *stare decisis* was important because the North Dakota State Supreme Court had previously determined that *Bellas Hess's* physical presence rule no longer applied due to the evolution of the US Supreme Court's Commerce Clause jurisprudence.

967 *Quill Corp. v. North Dakota*, 504 US 313 (1992).

> the Bellas Hess rule, a publisher who included a subscription card in three issues of its magazine, a vendor whose radio advertisements were heard in North Dakota on three occasions, and a corporation whose telephone sales force made three calls into the State, all would be subject to the collection duty. What is more significant, similar obligations might be imposed by the Nation's 6,000-plus taxing jurisdictions. See National Bellas Hess, Inc. v. Department of Revenue of Ill., 386 U.S. 753, 759-760 (noting that the "many variations in rates of tax, in allowable exemptions, and in administrative and recordkeeping requirements could entangle [a taxpayer] in a virtual welter of complicated obligations").'

The *Quill* decision has been widely criticized. The case was nominated for "the most maligned Supreme Court tax decision".[968] Numerous commentators have called for the Court to revisit the decision or for Congress to pass legislation enabling states to tax out-of-state sellers. However, it should be kept in mind that the *Quill* decision was not based on any notion that remote sellers ought to be placed in a tax-advantaged position as compared to local retailers. The Supreme Court recognized that interstate commerce may be required to pay its fair share of state taxes when it held in *Commonwealth Edison* (1981)[969] that:

> 'To accept appellants' apparent suggestion that the Commerce Clause prohibits the States from requiring an activity connected to interstate commerce to contribute to the general cost of providing governmental services (...) would place such commerce in a privileged position. But as we recently reiterated, "[i]t was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business".'

However, states will not be allowed to collect use taxes from out-of-state sellers as long as remote sellers bear increased reporting and payment obligations as a result of their participation in interstate trade. Whereas a seller operating exclusively within a single state must only bear the tax collection costs imposed by that state's sales or use tax system, in the absence of the Commerce Clause nexus, a seller operating in many states would bear tax collection costs of the use tax of each state to which he ships goods.

A common misinterpretation of the physical presence test is that it requires either the presence of tangible property or employees within a state to establish nexus. In *Scripto Inc. v. Carson* (1960), the Supreme Court held that agents soliciting on behalf of a corporation satisfied the nexus requirement under

968 P.L. Caron, *Pepperdine Hosts Symposium on the Most Maligned Supreme Court Decisions,* Tax Prof. L. Blog (1 Apr. 2011), available at: http://taxprof.typepad.com/taxprof blog/2011/04/supreme-mistakes.html.

969 *Commonwealth Edison,* 453 US at 623-624 (1981).

both the Due Process and Commerce Clause.[970] Similarly, in *Tyler Pipe Industries v. Washington* (1987),[971] the Supreme Court held that the corporate taxpayer had substantial nexus in Washington based on activities performed in the state on behalf of the corporation. The Court reached this result even though the corporation had no office, property or employees in the state. The judgments in *Scripto* and *Tyler Pipe* indicate that the physical presence requirement may be satisfied by the in-state activities of others taken on behalf of an out-of-state retailer. Nexus based on the activities of another is referred to as attribution nexus because the in-state activities of others are attributed to the out-of-state seller. Attribution nexus disregards certain formal distinctions, such as whether the in-state activities are performed by an employee or an independent agent, and, instead, focuses on the nature and extent of the activities themselves, in particular, whether they allow the taxpayer to establish and maintain a market in the state.[972]

Finally, it is important to note that the fact that a taxpayer has nexus for sales tax purposes does not imply that he will also have nexus for income tax purposes.[973] Both concepts are similar and both are heavily rooted in the Commerce and Due Process Clause. However, different levels of activity within a state may trigger one type of nexus but not the other. The federal legislator passed Public Law 86-272, according to which states cannot collect income tax from corporations whose only activity within the state is the solicitation of orders for tangible personal property.

#### *8.2.2.3 "Amazon" laws*

The reliance on physical presence nexus has created planning opportunities for taxpayers in mail-order and online businesses. As the electronic commerce grew, the potential loss of revenue became a serious concern for the states. In 2010, electronic commerce in the United States exceeded USD 4.1 trillion, with USD 424 billion of that amount comprised of consumer purchases. From 2002 to 2010, retail online sales increased at an average annual growth rate of 17.9%, compared to 2.6% for total retail sales.[974]

Frustrated by the *Quill* decision and desperate for revenues, a number of states have passed legislation, commonly referred to as "Amazon" laws, which aggressively interprets the physical presence requirement in an attempt to tax

970 *Scripto Inc. v. Carson*, 362 US 207 (1960).
971 *Tyler Pipe Industries v. Washington*, 483 US 232 (1987).
972 A. Haile, *Affiliate Nexus in E-Commerce*, Elon Univ. Sch. of Law, Legal Studies Research Paper No.2011-04, sec. I.C, available at: http://ssrn.com/abstract=1924510.
973 S. Lusch, *State Taxation of Cloud Computing*, 29 Santa Clara Computer & High Tech. L. J., p. 380 (2013).
974 US Census Bureau, *E-commerce 2010*, (10 May 2012), available at: www.census.gov/econ/estats/2010/2010reportfinal.pdf.

interstate electronic commerce.[975] Although there is a considerable variation in the content of "Amazon" laws, they generally try to assert nexus through affiliation (related-entity approach) or referral (click-through nexus).[976]

Click-through nexus legislation triggers use tax liability for remote sellers who solicit sales through state residents. The remote supplier must have an agreement with state residents according to which the latter refer to him potential customers (for example, by a link on a website) and gross receipts from sales in that state must exceed a certain threshold. New York was the first state to enact click-through nexus legislation in 2008.[977] In 2009, Rhode Island and North Carolina adopted identical laws.

Affiliate nexus exists if a remote seller and a state business are under common control or if they use a similar name or trademark to promote and maintain sales. This kind of nexus attempts to circumvent the Commerce Clause prohibitions by disregarding the corporate structure and treating related business entities as though they were a single unitary business.[978] In 2010, Colorado adopted a law under which if a "controlled group of corporations" had at least one member with physical presence in Colorado, all retailers in the group had nexus with Colorado.[979] In 2011, California amended the definition of a "retailer engaged in business in California" to include certain affiliates of in-state companies and to require them to collect use taxes.[980] The affiliate nexus provision was reportedly targeted at Amazon, which has a research and development facility (operated by an Amazon subsidiary) in the state.

Affiliate nexus is similar to attribution nexus, but those two concepts are not exactly the same. Attribution nexus means that the actions of an in-state representative establish and maintain a market for an out-of-state entity. Affiliate nexus applies if the in-state and out-of-state entity satisfy a common ownership requirement. These two concepts overlap when an in-state affiliate is performing services for an out-of-state retailer, those services are essential

975 For detailed discussion of Amazon Laws and their constitutionality, *see Amazon.com v. New York State Department of Taxation and Finance*, 877 N.Y.S.2d 842 (N.Y. App. Div. 2009); T. Cavanaugh, *Iowa Can Do Better than the Affiliate Tax: A Proposal for an Intermediary Tax*, 97 Iowa L. Rev., p. 567 (2012); D. Cowan, *New York's Unconstitutional Tax on the Internet: Amazon.com v. New York State Department of Taxation and Finance and the Dormant Commerce Clause*, 88 N.C. L. Rev., p. 1423 (2010); S. W. Gaylord & A. Haile, *Constitutional Threats in the E-Commerce Jungle: First Amendment and Dormant Commerce Clause Limits on Amazon Laws and Use Tax Reporting Statutes*, 89 N.C. L. Rev., p. 2011 (2011); T.S. Steele et al., *The 'Amazon' Laws and the Perils of Affiliate Advertising*, 59 St. Tax Notes, p. 939 (28 Mar. 2011); Haile, *supra* n. 972.

976 States that passed Amazon laws include: Alabama, Arkansas, California, Georgia, Idaho, Indiana, Kansas and Minnesota.

977 Gamage & Heckman, *supra* n. 961, at p. 518 et seq.

978 Id., at p. 520 et seq.

979 J. Henchman, *Amazon Taxes*, p. 36, The Tax Foundation (July/August 2012).

980 Assembly Bill No. 155, passed by the California State Legislature on 9 Sep. 2011 and signed by Governor Brown into law on 23 Sep. 2011.

to establishing and maintaining a market for the retailer and they are part of a unitary business between the affiliate and the retailer.[981] The Supreme Court has not yet considered the application of affiliate nexus in the use tax context. Several lower courts have uniformly rejected it.[982]

"Amazon laws" do not offer an effective solution for taxing interstate electronic commerce. These laws have been described as unconstitutional and they have been the subject of litigation across the country. Courts are extremely reluctant to disregard the separate legal status of distinct entities, even if those entities are affiliates. This reluctance is based on the fundamental principle of corporate law that the parent company and its subsidiary are treated as separate and distinct legal persons, even though the parent owns all the shares in the subsidiary and the two enterprises have identical directors.[983] Moreover, since use tax is imposed on the consumer's act of using personal property, it has no relation to the corporate structure of the retailer selling the property.

Remote suppliers found a way of circumventing "Amazon" laws by moving their subsidiaries or suspending their relationships with marketing organizations from the states that passed such laws. Amazon responded to the New York law establishing the click-through nexus by terminating its affiliate programmes in the state and filing a lawsuit in state court. Thus, the first "Amazon" taxes did not result in more revenue. Rhode Island actually saw revenue loss due to reduced income tax collections from terminated affiliate's relationships.[984]

### *8.2.2.4 Proposed legislative measures*

While efforts to enact "Amazon" laws continue at the state level, the dubious constitutionality of those laws and their lack of success in raising revenue has shifted attention to the federal level where there have been several attempts to adopt a new nexus standard. Almost every year since the *Quill* decision in 1992, new legislation that would grant states the authority to compel remote sellers to collect state sales and use taxes has been proposed.[985]

981 Haile, *supra* n. 972, at sec. I.C.

982 *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666 (1991); *SFA Folio Collections, Inc. v. Tracy*, 652 N.E.2d 693 (Ohio 1995); *Current, Inc. v. State Board of Equalization*, 24 Cal. App. 4th 382 (Cal. Ct. App. 1994).

983 *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 673 (1991) (quoting H. Henn and J. Alexander, Laws of Corporations (3d ed. 1983) sec. 148, p. 355).

984 Haile, *supra* n. 972, at sec. I.C.

985 The Main Street Fairness Act (S. 1452/H.R. 2701) introduced on 29 July 2011; the Marketplace Equity Act (H.R. 3179) introduced 13 October 2011; and the Marketplace Fairness Act (S. 1832) introduced 9 November 2011.

The Market Fairness Act of 2013[986] has made the greatest progress so far. It grants the states the authority to compel remote sellers to collect sales tax at the time of a transaction just as local retailers are already required to do. However, before states are allowed to start collecting tax from remote sellers, they must simplify their sales tax laws. The Act provides for two simplification options. The first one is to join the Streamlined Sales Tax Project (*see* section 8.2.2.5.) and the other – to introduce simplification measures listed in the proposed bill. For states which do not participate in the Streamlined Sales Tax Project, the minimum simplification requirements are as follows:

- there must be a single entity within the state to administer all state and local sales and use taxes, a single audit for all taxing jurisdictions within the state and a single return to be filed with the single administering entity;
- the state cannot require a remote seller to file sales and use tax returns more frequently than it is required for non-remote sellers or impose requirements on remote sellers that the state does not impose on non-remote sellers;
- there must be a uniform sales and use tax base among the state and local taxing jurisdictions;
- remote sales must be sourced to the location "where the item is received by the purchaser" (destination principle);
- the state must provide remote sellers with information about the taxability of goods and services and the rates;
- the state must provide free software for remote sellers to calculate and file sales and use tax returns and hold them harmless for any errors and omissions resulting from relying on state-provided systems and data.

Sellers whose nationwide remote sales did not exceed USD 1 million in the preceding year are not required to collect sales and use taxes on those sales (the small seller exemption). As the exemption threshold refers to "gross annual receipts in remote sales", remote sellers that primarily sell non-taxable items may also be subject to collection and remittance obligations. By way of example, a seller with remote sales of non-taxable items of USD 950,000 that also sold taxable items in the value of USD 55,000 would still be required to collect tax on the USD 55,000 of remote sales of taxable items since he would not qualify as an exempt small seller.

The Market Fairness Act of 2013 intends to provide some level of sales tax simplification in an effort to make it easier for remote sellers to comply with the collection and remittance obligations. Although it does not address

986 *See* http://beta.congress.gov/bill/113th-congress/senate-bill/743. The Marketplace Fairness Act of 2013 was introduced in the Senate as S. 743 (formerly S. 336) on 16 April 2013, and in the House of Representatives as H.R. 684 on 14 February 2013. It was passed by the Senate on 6 May 2013. For more information on the Market Fairness Act of 2013, *see* www.marketplacefairness.org/what-is-the-marketplace-fairness-act/.

one of the main concerns of the remote sellers, i.e. significant differences among the states as to which goods and services are taxable, it provides remote sellers with free-of-charge software that calculates sales and use taxes due on each transaction and it holds them harmless for any errors or omissions that result from relying on state-provided systems and data.

### *8.2.2.5 Simplification efforts by states*

The US Constitution does not provide a nationwide forum in which the states can meet to seek uniformity in policies or rules that govern cooperative arrangements between them. On the contrary, the US Constitution imposes restrictions on the ability of the states to collaborate with each other on tax administration. The Compact Clause[987] generally prohibits interstate agreements without the consent of Congress. Thus, congressional approval is required for a state to enter into an agreement to collect sales taxes on a uniform basis.

In an effort to simplify and to gain consistency on the structure of sales taxes, a group of states established the Streamlined Sales Tax Project (SSTP).[988] The result of this work was the adoption of the Streamlined Sales and Use Tax Agreement (SSUTA) in November 2002.[989] The SSUTA focuses on improving sales and use tax administration systems by developing uniform definition and sourcing rules for taxable transactions and by simplifying compliance matters, thereby minimizing costs and administrative burdens on retailers operating in multiple states. It encourages remote sellers to collect tax on sales to customers living in the streamlined states to ensure a level playing field between online shops and local "brick-and-mortar" stores. The governance of the SSUTA is in the hands of the Governing Board, which has the form of a non-profit entity. All full and associate member states have a seat on the Board. The ultimate goal of the SSTP is to persuade the federal government to allow tax collection on interstate trade by demonstrating the states' willingness to achieve uniformity in taxation.

Under the SSUTA, all local sales and use taxes must be administered by the state. Sellers are only required to register and file returns with the state that redistributes the revenues to the local governments. The tax base for state and local jurisdictions must be identical. Participating states agree to reduce compliance burden for sellers by making a reasonable effort:
- to notify sellers of legal changes in the tax base, rate and other rules and regulations;
- not to apply multiple tax rates;

987 Art. 1 (10) of the US Constitution.
988 *See* http://streamlinedsalestax.org.
989 For an overview of the SSUTA, *see* Van Brederode, *The Harmonization of Sales and Use Taxes in the United States, supra* n. 953.

- to maintain a database that describes the boundaries of all taxing jurisdictions according to the five and nine-digit zip code.

The participating states must provide monetary compensation for the implementation of new technology in the case of voluntary registration, i.e. registration in a state where the seller lacks sufficient nexus. The SSUTA provides for three compliance models. In Model 1, sellers employ a Certified Service Provider (CSP) to perform all their sales and use tax functions.[990] CSPs are liable to the tax authorities for any errors made. The services rendered by CSPs are paid for by the participating states. If registration in a particular state is mandatory, for example because the seller has sufficient physical presence (nexus) there, no compensation will be paid under the terms of the CSP contract in respect of taxes due to that particular state. In Model 2, sellers retain their responsibility in respect of sales and use taxes and use Certified Automated Systems (CAS) software to perform compliance functions. The CAS identifies which products are taxable, applies the appropriate tax rate and can be linked to the company's accounting system. The costs of the CAS software are borne by the businesses employing them. Finally, Model 3 sellers use their own system to make their tax calculations on the basis of performance standards determined by the individual participating states.[991]

Until December 2013, 24 states have passed the conforming legislation. Those states represent about 31% of the country's total population.[992] However, some important states, like California and New York, have not joined the project yet.

## 8.2.3 Basic characteristics of sales taxes

### *8.2.3.1 Personal scope*

The sales tax does not know the concept of taxable person, similar to that under the EU VAT law. The seller or retailer is responsible for sales tax collection and remittance, provided that he has sufficient nexus with the state.

As regards liability for the payment of tax, a distinction must be made between seller privilege tax (SPT) and consumer tax (CT) states. In SPT states, the tax is imposed on the privilege of doing business in the state. The tax subject is the retailer who must remit the tax whether or not it is collected from the customer. In CT states, the tax is imposed on the privilege of con-

990 For a list of CSPs, *see* www.streamlinedsalestax.org/index.php?page=certified-service-providers.
991 *See* www.streamlinedsalestax.org/index.php?page=reg_3.
992 *See* www.streamlinedsalestax.org/index.php?page=About-Us.

suming the goods and services purchased. The tax subject is the consumer, but the responsibility for tax collection rests on the retailer.[993]

The sales tax and the VAT employ different techniques to avoid taxing business purchases. The US retail tax system does not know the concept of input tax. Sales and use taxes are only imposed on the ultimate consumer. Retailers, manufacturers and wholesalers are exempt on their sales under the resale/manufacturing exemption. Despite this, it is estimated that more than 40% of sales tax revenues are derived from business purchases, which results in tax cascading effect that distorts choices among productive techniques.[994]

There are neither registration thresholds nor simplifications measures for small businesses. Any person, regardless of his turnover, which establishes nexus in a taxing jurisdiction and makes taxable sales is required to register, collect and remit sales tax. The filing frequency can be lower if the average tax liability is low.[995]

#### *8.2.3.2 Taxable transactions*

*General information*

In general, all sales of tangible personal property are taxable.[996] A "sale" is defined as any transfer of title or possession, exchange or barter of tangible personal property for consideration.[997] Some states have expanded their definition of tangible personal property to include items such as electronically delivered software and digital products, as well as some commodities (for example, natural gas and electricity).[998]

Intangibles are excluded from the RST scope in the majority of states. However, there are some states (for example, Hawaii, New Mexico and South Dakota) that tax almost all services, and in those states the sale of intangibles is taxable to the extent that the intangibles are considered services.[999] Intangible property is treated as tangible property if it is transferred in a tangible format, for example, software delivered on a data carrier.[1000]

Most states tax only a few enumerated services. When sales taxes were enacted, services accounted for a substantially smaller fraction of national output than now. Thus, the failure to tax them did not cause a serious loss

993 D.L. Yetter, *United States – VAT & Sales Tax*, sec. 2, Topical Analyses IBFD.
994 C.E. McLure Jr. & P. Merrill, *Why Doesn't the United States Use a VAT for Deficit Reduction? Political Impediments and Fiscal Coordination Issues*, sec. 4.2., 67 Bull. Intl. Taxn. 4/5 (2013).
995 Yetter, *supra* n. 993, at sec. 12.1.
996 Sales tax statutes do not distinguish between legal and illegal supplies, both of which are subject to tax. *See Greer v. Department of the Treasury*, 145 Mich. App. 248, 377 N.W.2d 836 (1985).
997 Yetter, *supra* n. 993, at sec. 3.1.2.
998 Id., at sec. 3.1.1; Lusch, *supra* n. 973, at p. 376.
999 Nelson et al., *supra* n. 955, at sec. 6:52.
1000 Yetter, *supra* n. 993, at sec. 3.1.1.

of revenue. Over time, the economic landscape of the United States has changed, but sales taxes have not reflected those changes. Although now services comprise a larger share of national output than goods, service providers have been able to defeat proposals to extend the tax to the service sector. There is an understandable reluctance for the states to apply sales taxes to services. The main reason is the lack of uniformity in the definition of what may constitute a service and in the rules to determine which state may tax interstate services. In the absence of such rules, a service contracted in one state, performed in another and used by the customer in several other states may be subject to multiple taxes.[1001]

A retailer or service provider is required to charge, collect and remit sales or use tax on all transactions subject to tax in a given jurisdiction, except when the provisions in that jurisdiction allow for a sale to be exempt. The states apply exemptions to certain categories of goods and services, for example, food, medical supplies and educational materials. The determination of which goods are taxable or exempt varies among the states.

Many states allow an exemption for occasional or casual sales as these types of transactions are generally not made in the regular course of business. The states vary on what types of transactions may qualify for this type of exemption. The exemption is sometimes limited to a certain number of sales or a specified dollar amount. If a taxpayer exempts a transaction believing that the threshold will not be exceeded, but within the specified time period the sales value does exceed the threshold, all past sales are subject to tax. New York only exempts occasional sales of property sold by individuals at a residence (i.e. garage sales). California does not consider sales by anyone holding a retail permit to qualify for a casual sale. In Alabama, an exemption applies to items sold outside the normal course of business (for example, a publishing company selling computers).[1002]

*Barter transactions*

The concept of sale includes barter transactions. Two parties to a barter transaction function as both "buyer" and "seller" and the goods and services exchanged serve, in turn, as both the items sold and the consideration paid. Barter is subject to the general sales tax rules.

The following example explains the tax treatment of a barter transaction under the RST rules. If the "seller" of taxable goods sold in a barter transaction is a New Jersey vendor (i.e., a vendor who has sales tax nexus with New Jersey or a vendor without nexus who has voluntarily chosen to register as a vendor in this state), the seller should collect and remit sales tax calculated on the normal retail value of the item sold, assuming that the purchaser cannot claim a valid statutory exemption (for example, resale, exempt organization or

1001 Van Brederode, *Introduction to the US State Sales and Use Taxes*, *supra* n. 771, at sec. 6 and 7.
1002 Yetter, *supra* n. 993, at sec. 2.3.

production equipment). The normal retail value is the price at which goods or services of the same kind are offered for sale by him to retail customers paying by traditional means (money). If the seller is an out-of-state vendor, not registered in New Jersey, who delivers taxable goods to a New Jersey customer in a barter transaction, the New Jersey customer will be liable for remitting the use tax. The New Jersey customer will owe the tax on the value of the consideration that he paid. This consideration will consist of the goods or services that he gives to the seller in lieu of money.[1003]

*Classification of digital goods*
When digital goods first entered the marketplace, the existing statutes and regulations focused on taxation of supplies of tangible personal property and specifically enumerated services. In the absence of statutory or administrative provisions imposing tax on digital goods, sales of such goods were generally not considered taxable because the consumer did not receive any tangible personal property. Over the last few years, as states have been looking for ways to expand their sales tax bases in order to increase revenues, new statues and regulations have appeared to address the taxation of digital goods. Among the states' approaches to taxation of digital goods, three trends can be identified.

First, there are states that still have not addressed the issue of taxation of digital goods. As they tax only tangible personal property, digital goods escape taxation due to their intangible nature. Second, there are states that tax digital goods because such goods are considered to be tangible property. The Texas Tax Code provides the following definition of a taxable item:[1004]

> '"Taxable item" means tangible personal property and taxable services. Except as otherwise provided by this chapter, the sale or use of a taxable item in electronic form instead of on physical media does not alter the item's tax status.'

The Louisiana Revised Statute defines tangible personal property as property which may be seen, weighed, measured, felt or touched, or is in any other manner perceptible to the senses.[1005] However, the Administrative Code provides examples of tangible property, including:[1006]

> 'digital or electronic products such as "canned" computer software, electronic files, and "on demand" audio and video downloads.'

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1003 New Jersey State Tax News, vol. 30, no. 1 (Spring 2007), available at: http://www.state.nj.us/treasury/taxation/pdf/pubs/stn/spring07.pdf.
1004 Texas Tax Code 151.010.
1005 Louisiana Revised Statute 47:301(16)(a).
1006 Louisiana Administrative Code 61:I.4301(C) (Definition of Tangible Personal Property).

Relying on prior case law according to which electricity constituted tangible personal property,[1007] the Alabama Department of Revenue (Administrative Law Division) ruled that a photographer's sale of digital images transmitted electronically was subject to sales tax because the digital images constituted tangible personal property:[1008]

> 'Whether sales tax applies to the sale of digital goods delivered electronically is an emerging issue in state taxation. Admittedly, treating the sale of digitized photographs delivered electronically as a taxable sale of tangible personal property pushes the bounds of what has traditionally been viewed as the sale of tangible goods. But Alabama's broad definition of tangible personal property, which the Alabama Supreme Court has construed to include electricity, is sufficiently broad to include digital goods transmitted by electrical impulses. I also see no principled reason why the retail sale of goods that can now be delivered electronically due to advances in technology, i.e., photographs, music, movies, books, etc., should be taxed any differently than the sale of those goods delivered by traditional means.'

The third approach includes states that have enacted a definition of digital goods and impose tax on such goods. The majority of those states are members of the Streamlined Sales Tax Project. Under the SSUTA, member states must not include "any products transferred electronically"[1009] in the definitions of "tangible personal property", "computer software",[1010] "telecommunication services" or "ancillary services".[1011] A member state may choose to tax products transferred electronically by enacting special rules but not by including those products within one of the categories specified above. For states that impose a tax on products transferred electronically, section 332(D) of the SSUTA provides that, unless the statute specifically states otherwise, a tax on such products shall be construed as being imposed on a sale that grants the right of permanent use to an end user and that is not conditioned upon continued

1007 In *Curry v. Alabama Power Co.*, 8 So.2d 521 (Ala. 1942), the Alabama Supreme Court held that electricity, i.e. the flow of electrons, constituted tangible personal property for sales and use tax purposes. The Court later confirmed that holding in *State v. Television Corp.*, 127 So.2d 603 (Ala. 1961), and *Sizemore v. Franco Distributing Co., Inc.*, 594 So.2d 143 (Ala. Civ. App. 1991).

1008 *Robert Smith d/b/a FlipFlopFoto v. State Department of Revenue*, Admin. L. Div. Dkt. No. S051240.

1009 The term "transferred electronically" means obtained by the purchaser by means other than tangible storage media (sec. 333 of the SSUTA).

1010 According to the definition in Appendix C Part II of the SSUTA, "computer software" means a set of coded instructions designed to cause a computer or automatic data processing equipment to perform a task.

1011 Sec. 332A and 333 of the SSUTA. Before 1 January 2010, the restriction applied only to "specified digital products" defined as digital audio-visual works, digital books and digital audio works.

payment to the seller by the purchaser.[1012] A person that purchases products "transferred electronically" for the purpose of giving away such products shall not be considered to have engaged in the distribution or redistribution of such products and shall be treated as an end user.[1013]

Although the SSUTA lays down conditions under which the sale of products transferred electronically should be taxable, many SSUTA member states have deviated in their statutes from the SSUTA provisions. Some states consider a sale of digital products taxable even if the right to use a digital item is not permanent or the purchaser is obliged to make continuous payments. North Dakota took a different approach: it adopted the definition of products transferred electronically provided by the SSUTA and then exempted those products from taxation.[1014] On the other side of the spectrum is South Dakota, which has taken the broadest approach to taxing digital products: all sales, leases and rentals of electronically transferred products are taxable.[1015] Thus, even among the SSUTA member states – where one might expect some consistency – a taxpayer must study each statute individually and cannot make a determination regarding the taxability of digital goods in one state based upon its knowledge of the taxability of digital goods in another one.

Form the above-mentioned considerations, it can be concluded that the characterization of virtual currency for sales tax purposes varies from state to state. In states that do not tax intangibles or services, transactions involving virtual currency are not subject to sales tax. Under the SSUTA, virtual items and currency qualify as "products transferred electronically".[1016]

#### *8.2.3.3 Place of taxation*

In the United States, sales taxes apply only to domestic (i.e. intra-state) supplies, i.e. supplies that originate and end within the boundaries of the same state. States have no authority over out-of-state suppliers because interstate trade is the exclusive domain of the federal government. Under the current judicial interpretation of the Commerce Clause, only sellers with adequate physical presence (nexus) are required to register as use tax collectors. Thus, sellers of digital goods are generally not required to charge sales tax when

1012 Sec. 332D of the SSUTA.

1013 Sec. 332D(1) of the SSUTA. However, this provision excludes a person who receives by contract a product transferred electronically for further commercial broadcast, rebroadcast, transmission, retransmission, licensing, relicensing, distribution, redistribution or exhibition of the product, in whole or in part, to another person or persons (Rule 332.1).

1014 S.B. 2347, 61st Gen. Assem., Reg. Sess. (N.D. 2009).

1015 South Dakota Department of Revenue, *Factsheet "Products Transferred Electronically"* (Mar. 2011), available at: www.state.sd.us/drr2/businesstax/publications/taxfacts/digital.pdf.

1016 Sec. 332G of the SSUTA clarifies that the tax treatment of a "digital code" shall be the same as the tax treatment of the "specified digital product" or product "transferred electronically" to which the "digital code" relates.

the goods are sent to a customer in a different state or country. In an interstate scenario, the obligation to calculate and remit the tax is shifted to the customer. However, the customer will have little incentive to fulfill his obligations knowing that the probability that the tax authorities will find out about the transaction is very low.[1017] If the customer (a non-taxable person) is resident of the European Union, the seller becomes obliged to register in a selected Member State under the One Stop Shop arrangement. However, the seller may not be aware of his obligation to register or he is unlikely do so given the low probability of enforcement and detection.

The determination of whether a transaction takes place within a state jurisdiction depends on where the transfer of title or possession occurs. This is generally the location where the goods are shipped to the customer by the retailer. The place of taxation for services is usually the location where the service is performed or where the benefit of the service is enjoyed or where the customer makes first use of the service.[1018]

The sourcing rules for digital goods depend on their characterization for state sales tax purposes. States that treat digital goods as tangible property follow the sourcing provisions applicable to other tangible goods. Given the intangible nature of digital goods and the characteristics of the electronic means of delivery, the application of rules on sales of tangible property may give rise to significant difficulty. For example, when bitcoins are exchanged for traditional currency, it is unclear when the delivery occurs (i.e. whether the location of the buyer, the seller or the equipment supporting the transaction is decisive).

Under the SSUTA, the sourcing of digital goods follows the five-step sourcing hierarchy laid down in section 310A. First, if the digital good is "received" by the purchaser at a location of the seller, the sale takes place at that location.[1019] The term "received" means taking possession or making the first use of digital goods, whichever comes first.[1020] Second, if the product is not received at the location of the seller, the sale occurs where the purchaser receives the product, as long as that location is known to the seller.[1021] If neither of the above applies, the place of supply is the location of the purchaser available from the seller's business records (the third step)[1022] or an address of the purchaser obtained during the consummation of the sale (the fourth step).[1023] Finally, if none of the above applies, the seller is to source the transaction to the location from which the product was provided.[1024] The first

1017 *See* section 8.2.4. *Basic characteristics of use taxes*.
1018 Yetter, *supra* n. 993, at sec. 4.
1019 Sec. 310A.1 of the SSUTA.
1020 Sec. 311C of the SSUTA.
1021 Sec. 310A.2 of the SSUTA.
1022 Sec. 310A.3 of the SSUTA.
1023 Sec. 310A.4 of the SSUTA.
1024 Sec. 310A.5 of the SSUTA.

rule is not likely to apply to virtual currency transactions since the customer seldom "takes possession" or "makes the first use" of digital goods at the seller's location. Similarly, the second, third and fourth rule have little practical relevance when the seller has no indications of the location of the customer. However, the catch-all provision appears to offer a workable solution; as a matter of last resort, a transaction can always be sourced to the location of the seller.

Some states are unwilling or unable to adopt the destination-based sourcing approach of the SSUTA. Origin-based taxation is a critical issue for states that permit local jurisdictions to tax intrastate sales that originate in their territory. The origin principle benefits not only local businesses that are required to collect tax for only one jurisdiction but also municipalities that are home to large retailers. To encourage those states to join the SSTP, the Governing Board amended the SSUTA to permit origin-based sourcing for intrastate sales of tangible personal property and digital goods.[1025] While the destination principle remains the rule for interstate sales, member states with local jurisdictions that impose or receive sales or use taxes may elect origin-based sourcing.

Just like in the case of the characterization of digital goods, there are no uniform sourcing rules among the SSUTA member states. A taxpayer must study each state statute individually and cannot make a determination regarding the sourcing of digital goods in one state based upon its knowledge of the laws of another one.

#### *8.2.3.4 Tax amount*

The sales tax rates vary from 2.9% to 7%.[1026] The applicable combined rate for a taxable sale is the state sales tax rate plus any local rates. The differences in tax rates result in cross-border shopping, i.e. consumers making their purchases in a state with a lower tax.

Contrary to the situation in the European Union, where VAT is included in the listed retail sales price, the US sales tax is an addition to the price. There is a dual rationale for separating the price from the tax. First, by stating the tax separately, customers are made aware of what they are paying for public services. Second, it makes it easier for suppliers to shift the tax forward to their customers and it prevents loss in sales volume when prices increase upon the introduction of the tax or when the existing rates are increased since the listed price is never affected by the tax.[1027]

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1025 Sec. 310.1 of the SSTUA (effective 1 January 2010).

1026 For a list of state sales tax rates, see http://salestaxinstitute.com/rates.html.

1027 Van Brederode, *Introduction to the US State Sales and Use Taxes*, *supra* n. 771, at sec. 2.

#### *8.2.3.5 Administrative obligations*

The sales tax administration is decentralized and handled at the state level, which means that persons seeking to register, collect and remit taxes are confronted with different rules in each state. Creating nexus in a state or a local jurisdiction generates the responsibility for a retailer or service provider to register, collect and remit sales and use tax. Registration to collect and remit sales tax can typically be administered online by completing an application form. Once an application has been processed and approved and the necessary certification is sent to the taxpayer, the taxpayer can legally initiate the collection and remittance of the sales tax. This is often referred to as the "retailer's permit."[1028]

Once a taxpayer is registered to collect or remit sales and/or use taxes in a jurisdiction, the jurisdiction will notify the taxpayer of their filing frequency and due date. Filing frequencies can change based on a taxpayer's level of sales activities. The due date applies to both the filing of the return and the payment of the tax.[1029]

### 8.2.4 Basic characteristics of use taxes

Use tax is defined as a tax on use or consumption of taxable items on which no sales tax has been paid. It applies to purchases made outside the taxing state but used within that state. Its aim is to prevent competitive disadvantage for domestic sellers.[1030]

Use taxes were initially enacted in the 1930's, shortly after states started passing sales tax laws. The original purpose of use taxes was to prevent residents from crossing state borders and purchasing goods in neighboring states which had not yet enacted sales taxes.[1031]

Use taxes must be remitted by the customer unless the seller has sufficient nexus in the state of destination. Thus, there are two types of use taxes: consumer use tax (CUT) and seller use tax (SUT). The former is self-assed by the customer on items on which no tax was collected by the retailer, whereas the latter applies to sales made by a retailer to a consumer located in another state if the retailer has nexus and is registered to collect tax there.[1032]

In practice, use tax compliance is drastically lower than sales tax compliance. Due to ignorance or intentional tax evasion, consumers rarely self-report transactions. The California State Board of Equalization estimates that only

1028 Yetter, *supra* n. 993, at sec. 11.1.1.1.
1029 Id., at sec. 11.4.1.
1030 Van Brederode, *Introduction to the US State Sales and Use Taxes*, *supra* n. 771, at sec. 8.
1031 Haile, *supra* n. 972, at sec. I.A.
1032 Yetter, *supra* n. 993, at sec. 2.

0.4% of individual taxpayers actually pay the use taxes they owe the state. Non-compliance with the use tax resulted in an estimated revenue loss of USD 1.2 billion in California in 2011.[1033] An empirical study on the sales tax compliance by eBay sellers showed that cross-border activity amounts to 92% of the total eBay activity. Coupled with a low level of use tax compliance, this creates a large threat to state tax revenues.[1034]

If state residents paid the use taxes they owe on e-commerce purchases, there would be no problem of taxation of interstate transactions since the states' inability to levy sales or use taxes on remote sellers would be remedied by the state residents paying use taxes on these purchases.

### 8.2.5 Conclusions

For most people, the Information Age has simplified their lives. However, for RST payers and administrators, the sales tax rules on digital goods have complicated an already confusing system. When digital goods first entered the marketplace, the existing statutes and regulations focused on taxing sales of tangible personal property and specifically enumerated services. Digital items were not considered taxable because the consumer did not receive any tangible items.

As the importance of the digital sector and electronic commerce grew, states started looking for ways to subject digital goods to taxation. The result of these efforts is a very inconsistent and complex set of rules that further complicates the multi-state sales tax system. In many states, virtual goods escape taxation due to their intangible nature. In others, they are considered to be tangible property and are taxed accordingly. The SSUTA has not offered a satisfactory solution to the characterization problem so far. Although it provides rules on taxation of digital products, many member states have deviated from the SSUTA provisions in their statutes.

Taxation of digital items is further complicated by the sourcing rules. As most states have not explicitly addressed the sourcing of digital goods, taxpayers and tax administrators face uncertainty in this area. The SSUTA failed to create uniformity in that matter either.

Another obstacle to taxation of digital goods is the fact that since the Supreme Court decisions in *National Bellas Hess* and *Quill*, interstate suppliers of digital goods have been effectively exempt from state sales and use taxes.

In view of the different issues discussed in this chapter, it can be concluded that the US tax system, in its present shape, is not ready to deal with problems imposed by virtual worlds and currencies. As the digital environment con-

1033 Haile, supra n. 972, at sec. I.A.
1034 Alm & Melnik, *supra* n. 728.

tinues to change at speeds that were unfathomable some years ago, state sales tax systems fail to keep pace.[1035]

## 8.3 International aspects

As a consequence of the spread of VAT and the increase in the volume of cross-border activities, transactions are frequently affected by indirect tax systems of two (or more) different jurisdictions. The differences in those systems and the lack of coordination at the international level may cause the same supply to be taxed twice or not taxed at all.[1036] Both phenomena are undesirable as they distort competition and violate the principle of neutrality. Conceptually, they should not exist: VAT is a tax on final consumption and should be applied by the state where the goods/services are most likely to be consumed. The main reasons for the existence of double taxation or double non-taxation are: the use of different rules to determine the place of taxation (or their different interpretation) and a different characterization of a supply. For example, state A levies VAT because it is the jurisdiction where the supplier is established, whereas state B taxes the same supply because it is the jurisdiction where the consumer is resident.

As VAT is harmonized within the European Union, the risk of double taxation or non-taxation is more common in transactions between Member States and third countries or between third countries themselves.[1037] Supplies of digital goods between the European Union and the United States are largely affected by double non-taxation.[1038] An EU taxable person supplying digital goods to a US customer does not charge EU VAT as the supply is deemed to take place outside the EU territory. The US customer should remit use tax on the received supply, but the probability that he will comply with his tax obligations is very low. A US seller supplying digital goods to an EU customer should charge VAT of the country of destination under the One Stop Shop regime. However, he may fail to do so since he is not familiar with EU VAT rules (which do not require nexus) or intentionally disregards them knowing that his tax liability is unlikely to be detected and enforced.

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1035 The statement that the digital environment changes rapidly can be illustrated by the following example: in 1989, Bill Gates said that they "will never make a 32-bit operating system". However, such system was introduced just four years later (*See* http://econsultancy.com/nl/blog/430-36-greatest-bill-gates-quotes-just-for-apple-fanboys).

1036 VAT/RST double taxation means that two countries levy VAT/RTS on the same supply, irrespective of whether the tax is levied on the same or different persons. Tax cascading is not covered by this definition.

1037 If double taxation occurs within the European Union, the ECJ may be called upon to solve the issue.

1038 With respect to direct taxes, the risk of unintentional double non-taxation is generally lower than with respect to VAT/RST as most direct tax systems tax their residents on a worldwide basis.

As shown above, the "import" of digital goods by consumers gives rise to non-taxation. Non-US sellers of digital goods have a competitive advantage over domestic sellers in the US market because of the difficulty of enforcing VAT on remote sales. The same applies in a reverse scenario of a non-EU seller supplying digital goods in the European Union. Due to their intangible nature, digital goods are not traceable and do not cross any borders. It is usually not possible for tax authorities in the country of destination to know the source of transactions, the identity of the recipient and the value of digital content, all of which are required to establish tax liability. The concept of use taxes has shown that it is unfeasible to collect tax on digital goods from consumers. A way must be found to collect tax from foreign sellers and this obligation must be supported by effective enforcement measures. The EU has found such a way by introducing the One Stop Shop regime. However, enforcing this regime in a digital context remains difficult as transactions can be carried out anonymously. Although millions of suppliers provide electronic services to EU consumers, only a few hundred of them are registered under the One Stop Shop scheme.[1039] Many fail to do so as the European Union does not have sufficient means to control and sanction them.

The introduction of a similar One Stop Shop regime in the United States does not seem a viable solution at the moment. Non-resident sellers cannot be required to apply the sales tax rate of the state of destination until the legal framework for taxing remote sales is changed, i.e. state sales tax laws are simplified and the physical presence test eliminated. Moreover, it would not be reasonable to require foreign suppliers to be involved in a "virtual welter of complicated obligations" imposed by the "nation's 6,000-plus taxing jurisdictions".

1039 *See* section 9.2.2.3. *One Stop Shop regime*.