

# COMMISSION OF THE EUROPEAN COMMUNITIES

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## COMPLETION OF THE INTERNAL MARKET AND APPROXIMATION OF INDIRECT TAXES

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL  
AND TO THE EUROPEAN PARLIAMENT

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1. Following the Commission communication of 4 August 1987 and the accompanying proposals (COM(87) 320 to 328), a wide-ranging debate has taken place on ways and means of removing tax obstacles to the establishment of the internal market.

There have been discussions on several occasions within the Council (Economic and Financial Affairs) and, on the initiative of the Council and the Commission, a number of working parties have looked into the matter. Particular mention should be made here of the work of the Economic Policy Committee and, since the beginning of 1989, of the deliberations of two working parties, one on the clearing system, which completed its work in April 1989, and the other, whose work is still continuing, on the allocation of VAT rates to different product categories.

2. As to objectives, a broad consensus has emerged on the prime importance for the internal market of the reforms to be undertaken in the field of indirect taxation. This consensus was reflected earlier in the new wording of Article 99 of the Treaty that resulted from the Single European Act.

General agreement has also been reached on the two main aspects of any action to be taken by the Community:

- approximation of the VAT and excise duty rates applicable in Member States;
- removal of tax frontiers incompatible with a genuine single market.

In this context, the views expressed on the Commission's proposed system, which ensures that goods circulate always bearing VAT, have not called into question the major qualitative advance which the system represents in two respects:

- on the one hand, progress towards the achievement of a true internal market, since goods will circulate within that market under the same conditions as within a Member State;
- on the other hand, progress towards a fundamental elimination of one of the major causes of tax evasion,

notably that which stems from the existence of two separate but far from watertight channels for the movement of goods - depending on whether they are taxed or untaxed.

In these circumstances the Commission is entitled to consider that such a method of taxation is best adapted to the idea of an economic space without internal frontiers.

3. As to method, however, major disagreements still exist, adding to the difficulties facing the undertaking. Where VAT is concerned, the discussions under way must be energetically pursued in order to reach a consensus. As for excise duties, the Commission has already indicated that it will be presenting new proposals to increase the flexibility of the measures to be taken.

The purpose of this communication is to clarify the new guidelines agreed by the Commission in connection with the objectives proposed in 1987. In order to help bring about an agreement within the Council as speedily as possible, the essential aim is to adopt a pragmatic approach to the main problems and to the possible solutions.

This suggests the need for a threefold strategy: introduction at the earliest possible opportunity of a transitional phase for the approximation of indirect taxes that will last until the end of 1992; a new approach to the VAT clearing arrangements; and new proposals on excise duty rates.

#### I. Transitional phase

4. The abrupt transition, on 1 January 1993, from the present arrangements for VAT rates and excise duty amounts to a new system without internal frontiers is bound to be a source of disruption for economic agents and for the conduct of national economic policies. The introduction of a transitional period will be conducive to the effective entry into force of the reforms on the envisaged date, with the necessary adjustments being accommodated in the meantime.

Evidently, the bulk of the preparatory adjustments are a matter for individual Member States, due regard being had to their own priorities and to national circumstances. Such is the case with the convergence of VAT and excise duty rates, already under way or planned in a number of Member States.

In this context it is worth emphasizing that in its reflections on the necessary modifications to be made to its initial proposals, the Commission has attached particular importance to foreseeable budgetary consequences, and has favoured measures which reduce the importance of these consequences to the greatest possible extent.

However, it is essential that the definition at Community level of a transitional period should be accompanied by steps to give practical shape to Member States' commitment to complete the internal market in the field of indirect taxation, especially as regards the approximation of VAT rates by the end of 1992.

5. This period would allow economic agents to prepare for the operational arrangements of the reform that would apply to them. It would also enable the introduction of certain procedural simplifications, so as to reinforce the preparatory nature of this transitional phase as a prelude to complete abolition of frontiers. In this context, proposals would be made to simplify Community transit procedures by abolishing the transit advice note.

6. Finally, in order to reinforce the process of market integration and the credibility of progress towards the single market as far as public opinion is concerned, the Commission proposes that this period should be marked by a gradual and substantial increase in travellers' allowances. Such an increase, which is being urged by Parliament, is entirely consistent with the prospect of a Peoples' Europe. Furthermore it ought to be attractive to the majority of economic operators:

- in foreshadowing the unlimited allowances and liberty of purchase, tax-paid, which will be the rule in the internal market from 1993;
- in accelerating the alignment of fiscal conditions, and in particular of VAT and excise rates, between the Member States.

To this end, the Commission intends to propose in three stages, beginning on 1 January 1990, 1 January 1991 and 1 January 1992 an increase of the order of:

- quadrupling the value of the VAT allowances;
- doubling the specific quantitative allowances for excisable products.

## II. VAT

### A. Approximation of rates

7. The Commission's proposal for two rate bands (4-9% for the reduced rate, and 14-20% for the standard rate) constitutes the basis for the discussions within the Council and the Parliament.

These discussions are concerned in particular with three matters: the width of the bands, which is often regarded as excessive and likely to bring about distortions of competition, notably in the case of the standard-rate band; the products to be charged with VAT at the reduced rate; and finally, the problem of zero-rated products.

#### Standard rate

8. An alternative to the rate band would be to replace it with a minimum rate applicable from 1 January 1993 without any upper limit being set for Member States insofar as the standard rate is concerned. Each Member State would choose a rate at least equal to the minimum rate, having regard not only to the national budgetary implications of its choice but also to the "competitive pressure" that would stem from the rates chosen by neighbouring Member States or by the Member States which were its main trading partners.

Such a minimum rate should make for a balanced sharing of the burden as between Member States with the highest VAT rates and the other Member States. This formula for a minimum rate is, therefore, simpler to apply than a rate band and takes better account of the autonomy and specific situation of each Member State.

9. It must also be acknowledged that, in the case of neighbouring Member States with widely differing rates and an important cross-frontier commercial traffic, it would be necessary to achieve a particularly close alignment of rates.

The Member States concerned could seek an agreement along these lines, in a form still to be determined. Their specific problem could thus be resolved without all the Member States being required to make an unnecessary effort.

#### Reduced rate

10. The Commission considers that the proposed band (4-9%) best meets the needs of the situation and that the essential task is to agree on the products to be taxed at the reduced rate relative to those chargeable at the standard rate. For the Commission, it is indispensable to reach agreement from the outset of the preparatory phase on the fact that a common structure based on two rates is the necessary condition for attaining a sufficient degree of alignment.

### Zero-rated products(1)

11. Existing Community legislation has regarded the zero-rating of certain products in several Member States as not constituting VAT rates proper but rather as being temporary derogations from the general principles of VAT, derogations that are associated with the continuation of a transitional situation.

However, in its initial proposals, the Commission did not rule out the possibility of retaining zero-rating after 1992 in the form of derogations linked to a new transitional period.

Since there is a twofold need to reduce the present coverage of zero-rating and to take account of the social role assigned to VAT in some Member States, a relaxation of the Commission's position could be envisaged provided a number of conditions were met.

It would be necessary, in the framework of a final compromise, to authorize Member States who so wish, to maintain zero-rating for a very limited number of products currently subject to the reduced rate, provided this did not pose any risks of distortion of competition for the other Member States. Such a measure could only be envisaged by the Commission if the Council reached an agreement on the respective coverage of the standard rate and the reduced rate.

### B. Differentiated approach

12. The main criticism levelled at the Commission's initial proposals concerned, on the one hand, the complicated and centralized nature of the clearing-house mechanism which is a potential source of budgetary conflict between Member States, and on the other hand, the risks of distortion of competition resulting, in so far as the purchases of final consumers are concerned, from rate differences which remain excessive for certain Member States. For private individuals the problem centres notably on mail order purchases and car purchases. For non-taxable institutional bodies and for exempt taxable persons the problem relates to their high-value purchases (for example, investment goods).

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(1) It is important to note that, unlike exemption which leaves the final consumer to bear input tax paid by the supplier, the zero rate involves the reimbursement of input tax, and consequently the product to which it applies is put into consumption totally untaxed, i.e. it is liable to no fiscal charge at all.

In order to help bring about an agreement within the Council, the Commission is suggesting in this communication a new approach whereby a number of transactions would be treated differently, at least while the rates are insufficiently aligned, and whereby a system of clearing or, rather, of refunds would be envisaged only for residual transactions between taxable persons.(2)

#### Mail-order (distance) selling

13. Most Member States have systems of selling by mail order, operated by large, specialised firms which base their activity on direct sales to final consumers and are also in direct contact with consumers in other Member States. It is important to avoid allowing differences in indirect taxation to become a source of distortion or of relocation of these enterprises.

The Commission is prepared to propose that for specialised operators, such sales should be taxed under the conditions applicable in the country of destination of the goods.

This system would not affect the principle under which any private individual can acquire goods, tax-paid, in the Member State of his choice.

#### Sales of cars

14. Sales of cars have often been cited as the typical example of transactions where distortions might arise due to disparities in tax rates that were considered to be excessive.

There is a possible technical solution which hinges on one of the characteristics specific to such items, viz. the fact that they are registered in the owner's country of residence. For VAT to be chargeable in the purchaser's country of residence, the place of supply would be defined as the place of registration. In such cases, the chargeable event would be the moment of registration.

In order to avoid any risk of tax evasion or arbitrary treatment, the conditions governing a change of residence would be those set out in existing Community legislation (Directive 83/183/EEC).

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(2) A taxable person is a physical or moral person carrying out economic activities liable to VAT.

Sales to institutional non-taxable persons and exempt taxable persons

15. It has also been pointed out that risks of distortion could arise from sales to such categories of "final consumers" as institutional non-taxable persons (bodies governed by public law and those treated as such) and exempt taxable persons (banks, insurance companies, etc.).

The purchases of these economic agents, and in particular their purchases of capital goods, in fact account for a considerable proportion of the sales of certain productive sectors. The danger of a shift of purchases from one country to another primarily for tax reasons, cannot therefore be ruled out, at least for purchases of considerable economic importance.

16. Here again, specific technical solutions can be found to counteract the potential consequences of rate differences in these special cases.

It could be stipulated, for example, that purchases in another Member State by these categories of operator should give rise, in the country in which these operators are established, to a self-supply procedure which would be taxable under the conditions applicable at the place of supply; or again that a differential tax should be instituted which would be equal to the difference between the VAT paid on purchase and the national VAT chargeable on similar goods or services.

These various solutions would help to reduce both the commercial and the budgetary risks to minimal proportions, while at the same time ensuring that the tax barriers to trade were removed.

It goes without saying that, over the long term, these specific arrangements would become progressively less necessary the more rates tended to converge.

Transactions of enterprises linked within the same group

17. One of the features of intra-Community trade is the considerable volume of trade between operators involved in the same industrial process, a significant proportion of which is carried out by enterprises within the same group. These enterprises offer a high degree of security because of the regularity of the flows of their transactions and the controls to which they are subject. This fact has already led a number of Member States, at national level, to suspend application of VAT to such transactions between linked companies, pursuant to Article 4(4) of the Sixth VAT Directive.



Subject to the necessary guarantees being provided, this possibility could usefully be extended to a portion of intra-Community trade. This arrangement should also be extended to associated small and medium-sized firms whose cross-frontier trade flows justify such action.

Intra-Community sales between approved members of a group would take place without VAT being applied. The chargeability of the tax would be deferred to the moment of resale by one of the associated enterprises to a non-approved non-associated purchaser. Enterprises would be able to operate under this arrangement only on the basis of the prior and conditional authorization of the Member State in which they were established.

#### The treatment of other transactions between taxable persons

18. The measures described above would provide a pragmatic solution to the principal difficulties which have arisen in the process of abolishing fiscal frontiers.

On the one hand this would be achieved by introducing ad hoc provisions to reduce the risk of competitive distortions in the most significant cases; on the other hand it would be achieved by operating a system of VAT suspension on intra-Community sales between associated companies. As a result, the question of deciding what formula to adopt for the "residual" operations of taxable persons should be capable of being dealt with in a reasonably dispassionate manner.

19. One of the implications of the movement of products "inclusive of VAT" is a so-called clearing mechanism. Given that the aim is for all of the VAT revenue to continue to accrue to the country of final consumption, it is necessary for the exporting country to pass on to the importing country the proportion of VAT collected in respect of the cross-frontier transaction. It should be noted that this requirement exists independently both of the abolition of fiscal frontiers and of the approximation of rates and would continue to exist even if rates were to be unified.

Serious reservations have been expressed by national fiscal administrations concerning the mechanism proposed by the Commission: on the one hand, it would not offer all the necessary guarantees as to control and might therefore be a source of dispute between countries; on the other hand, it would imply an excessively centralized administration.

However, the measures suggested above, which would reduce the volume of residual transactions substantially, open the way for a new approach to this question.

In these circumstances, it would seem that a macroeconomic approach to the clearing operation, which would present appreciable operational advantages, could also become politically acceptable.

20. The resultant simplification would be very substantial both for firms and for the tax authorities, since the Member States' debits and credits would no longer be calculated on the basis of the VAT returns of taxable persons but on the basis of trade statistics.

The mechanism thus set up could be easily operated, since the method of calculating transfers would be no more complex than that used for the new own resources.

There would be no central clearing fund but only an accounting exercise designed to establish the surplus balances to be refunded.

This mechanism would in addition be efficient because it would solve at a stroke a number of controversial technical problems: the problem of distributing the surplus resulting from the transactions of non-taxable persons and exempt taxable persons would be solved naturally; similarly, the statistical base would ensure a regular flow of transfers.

It goes without saying that an essential condition of such a system would be the maintenance of a high quality statistical system in the Community, the principle of which has been proposed by the Commission(3).

### III. Excise duties

21. The main criticism which the Commission has encountered here is that its initial 1987 proposal based on single rates per product for the whole Community lacks flexibility. More than in the case of VAT, the attempt at harmonization in this field highlights the continuing diversity of situation which persists in the Community.

In the case of the duties on tobacco and alcohol, this diversity is made all the more difficult to reduce due to the different circumstances of the Member States, according to whether they are producers or not. Finally, the degree to which public health requirements are reflected in the level of excise duties varies widely from one Member State to another.

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(3) COM(88) 810 Final. Proposal for a regulation (EEC) of the Council, on the statistics for trade in goods between Member States.

As it has already indicated, the Commission considers that flexibility is necessary and that this flexibility can vary according to the product in question, but that it must in no case result in putting at risk the principle of abolishing fiscal frontiers.

#### A. Gradual approximation

22. The different arrangements proposed should be based on reference values, long-term targets which reflect the Community's determination to move towards greater integration. These could be defined on the basis of the single rates established in 1987.

In this matter the Commission is aware that the recent development of health policies and of the need to protect the environment, justifies higher long-term targets than was the case in 1987.

The flexibility would take the form of minimum rates or rate bands based on these targets, according to the products in question.

#### Alcohol and tobacco

23. The Commission will propose that differentiated minimum rates, which would vary according to the principal products, should be compulsory from the end of the transitional period, i.e. from 1 January 1993.

In fixing the minimum rates, particular attention will be paid to countries with low excises so as to ensure that the effort they have to make remains reasonable. The solution reached cannot take the form of frontier controls.

The existence of these minimum rates would not prevent those Member States which apply the highest duties on such products from progressively aligning their duties on the long-term reference values adopted for each category of product.

#### Mineral Oils

24. It is important to pay particular attention to the risks of competitive distortion which are greater in this area than for alcohol and tobacco and result from excessive divergences between the duties applied to the different oil products by the Member States. For this reason the Commission will propose that either single rates or rate bands should be applied to the different products in the mineral oils sector, without rejecting a priori the fixing

of minimum rates in certain circumstances. In making its choice the Commission will pay particular attention to the links existing with other sectoral policies (transport, energy, environment).

#### B. Rules governing movement

25. It is an established principle that frontier checks should also be abolished for excisable products.

Individuals should thus be able to buy such products where they see fit and to transport them freely provided that commercial operations are not involved.

In order to facilitate intra-Community commercial operations and to guarantee that Member States are actually paid the duties due to them, proposals will have to be put forward concerning the conditions under which "interconnected" warehouses would function. These would enable operators to arrange for the movement of products while duties were suspended; duties would not become chargeable until the goods were definitively released from the warehouse procedure and put into consumption.

Finally, control measures will have to be implemented within Member States to prevent fraud based on the differences in duties between Member States, resulting from the flexible arrangements. These measures could take the form of tax stamps (bands, permits, etc.) guaranteeing that the appropriate duties had been paid in respect of the products marketed in a Member State.

Amended and supplementary proposals relating to excise duties are to be transmitted to the Council before August.

#### Conclusion

26. In order to ensure the success of the negotiations in progress on the crucial issue of tax frontiers, the Commission considers it necessary to make a number of suggestions and amendments to its proposals. These concern:

- the establishment of a transitional convergence phase operational from now until the end of 1992, during which:

- o Member States will be given every incitement to accelerate the approximation of their rates of VAT and excises;

- . procedural simplifications will be introduced in view of the final objective;
- . freedom to buy, tax-paid, in another Member State, will be introduced progressively by means of a gradual but substantial raising of the travellers' allowances;
- the adoption, as an alternative to the standard UAT rate band, of a system involving only one minimum rate applicable from 1 January 1993 and, in this context, encouragement for the reaching of agreements between certain Member States designed to reduce further the divergences between their rates;
- the introduction of specific arrangements for certain clearly defined commercial operations
  - . Mail order (distance) selling
  - . Sales of cars
  - . Sales to institutional non-taxable persons or to exempt taxable persons
  - . definition of a system of UAT suspension for intra-Community sales between associated enterprises;
- for the remaining transactions, a new macro-economic approach to the mechanism for refunding UAT balances;
- amendments to the proposals relating to excise duties designed to give them the maximum possible flexibility compatible with the requirements of completing the internal market.