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The Value-Added Tax in the European Economic Community

I. Introduction

The value-added tax (VAT) is the primary method for taxing production in the European Economic Community (EEC). While the VAT shares some of the characteristics of a sales or consumption tax, it actually operates as a multistage production tax. VAT taxes the increase in value of an item as it moves through the production chain. Unlike the direct retail sales tax used in the United States, which is applied once at the retail level, the VAT operates at every level of the production chain. This has the effect of hiding the tax in increased costs of production. This Note will briefly discuss the history and development of the VAT, its operation in the countries of the EEC, and problems associated with its operation which have been resolved by the European Court of Justice.

II. The History and Development of the VAT

The VAT, although now in effect in the countries of Western Europe,[1] was conceived by economic theorists in the United States in the early part of the twentieth century.[2] Early proponents of a VAT system in the United States argued that the sum of market values of effort expended at the various levels of the production process should be taxed.[3] They maintained that the recently developed calculations for gross national product supported the logic of such a value-added system.[4] Despite this early debate concerning adoption of such a system, the U.S. Congress has never enacted a value-added tax.[5] Several of the

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[1] The countries of the European Economic Community must, by the terms of the Community, adopt a VAT tax. *First Council Directive of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes*, Art. 1 (67/227/EEC), J.O. Comm. Eur. (No. 71) (1967). In addition, several European countries not in the Community including Austria, Norway and Sweden have adopted a VAT. D. Parkinson, Value Added Tax in the EEC 5 (1981).

[2] Lindholm, *The Origin of the Value-Added Tax*, 6 J. Corp. L. 11, 11–12 (1980).

[3] *Id.*

[4] *Id.* These early proponents included the American economists T.S. Adams and Paul Studensky. *Id.* at 12.

[5] Michigan adopted a VAT in 1953 and after a short period without it, has returned to a VAT system more recently. *Id.* at 12 n.10.

A recent attempt to adopt a national VAT tax met with defeat. H.R. 5665, The Tax Restructuring Act of 1979. *See* H. Aaron, The Value-Added Tax: Lessons from Europe 1 n.1 (1981).

countries of Western Europe, however, France being the first in 1954,[6] adopted a VAT system both to correct traditional tax systems which had proven distortionary and oppressive,[7] and to increase revenues in the wake of the financial crisis following World War II.[8] In 1967 the EEC adopted a VAT system with the First Directive, which instructs the member states of the EEC to replace their present system of taxation with a VAT.[9] By the time of issuance of the Sixth Directive in 1977, setting out much more detailed provisions for a VAT,[10] all of the original members of the EEC had instituted a VAT.[11]

III. THE OPERATION OF THE VAT

VAT as used in the EEC is a multistage tax on production with complex credit provisions to prevent distortion and abnormally high retail prices. Because the VAT is a regressive tax with respect to income,[12] the EEC uses complex rate differentials to mitigate the regressive effect. The basic functioning of the European VAT can be explained by a simple example:[13] Assume a VAT rate on generators of 10 percent and a production chain involving a metal cutter and molder (first stage producer), a generator engine assembler (second stage producer), and a generator assembler who also sells directly to consumers (assembler/retailer). If the first stage producer sells the cut metal to the second stage producer for 200, the value added tax payable by the former will be 20, or 10 percent of 200. The second stage producer then assembles the engine and sells it to the assembler/retailer for 400, paying a tax of 40. However, since the cost to him of the cut metal included the first stage producer's value added tax of 20, the second stage producer is permitted to take this 20 as a credit,

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[6] PARKINSON, *supra* note 1, at 5.

[7] For instance, France had a rigid single-stage production tax, which created an environment in which evasion was simple and in which over time the tax structure failed to represent consumption trends. PARKINSON, *supra* note 1, at 4. Other European countries had a multistage production tax with no credit provisions, creating distortions in ultimate retail price the longer the production chain proved to be. Carlson, *Value-Added Tax: Appraisal and Outlook*, 6 J. CORP. L. 37, 39 (1980). *See also* AARON, *supra* note 5, at 7–8.

[8] *The Origin of the Value-Added Tax, supra* note 2, at 13.

[9] *First Council Directive, supra* note 1.

[10] *Sixth Council Directive of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes—Common system of value added tax: uniform basis of assessment*, O.J. COMM. EUR. (No. L 145) (1977).

[11] PARKINSON, *supra* note 1, at 5.

[12] In other words the same rate of tax applies to everyone, so that consumers with high income are proportionally less burdened by the VAT than are consumers with low income, for whom any item of consumption represents a relatively larger precentage to total income.

[13] This example is a simplified version of those given in McDaniel, *A Value Added Tax for the United States? Some Preliminary Reflections*, 6 J. CORP. L. 15, 17–18 (1980) and INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, GUIDES TO EUROPEAN TAXATION, Vol. 4, *Value Added Taxation in Europe;* pt. 1, 8–9 (1986).

either deducting it from the tax she pays or in some cases receiving it as a refund. Note that the first stage producer, since he acquired the raw materials with no VAT imposed, will receive no tax credit. Finally, when the assembler/retailer sells the finished generator to the consumer for 500, she will be liable for a VAT of 50, but will be able to take a credit for 40, representing the tax carried by the item from the second and first stage producers. The gross tax liability for this production chain would be 110 (20 + 40 + 50), but net tax received by the government would be only 50 (20 + 20 + 10), or 10 percent of the final retail price of the generator. If the credits were not given, then each producer in the production chain would be paying a VAT on the value added plus the previous producer's VAT liability. This would drive the price of goods needing a longer production chain higher than similar goods needing only a short production chain. The credit is thus a means of offsetting double taxation or a cascade effect.

This system is carried out through the use of invoices which follow a given product through the production chain. The invoices serve as a record of taxes paid, and substantiate a claim for credit.[14] Unlike U.S. taxes, which are collected yearly, VAT is collected on a quarterly or monthly basis.[15] The VAT has proven to be an efficient system; its operations costs are low,[16] and its revenue generating ability is relatively high.[17]

The credit system reflects certain tax policy decisions. For instance, exports from the EEC nations are not taxed, and the exporter usually receives a full rebate of the value of all VAT that has accrued on the export.[18] This achieves two tax policy purposes. First, it gives the exporter an advantage in competing in foreign markets by removing the tax burden and allowing a commensurately lower export price. Second, it avoids double taxation on the same transaction, first on export and again on import.[19] On the opposite side of the credit system, all imports are subject to a VAT as if they had been produced by the country of importation.[20] This achieves the tax policy purpose of protecting the markets of importing nations from competition from underselling foreign exporters. The system does not raise the same competitive bar to exports of other EEC nations, however, because of the tax credit such exporters receive.[21]

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[14] PARKINSON, *supra* note 1, at 9.

[15] *Id.* at 37 and 186.

[16] In the United Kingdom, for instance, the cost of operating the VAT system as of 1980 had not exceeded 2 percent of the total amount collected. *Id.* at 78.

[17] In 1979, VAT brought in 40 percent of the revenues of the EEC nations. *Id.*

[18] H. AARON, VAT EXPERIENCES OF SOME EUROPEAN COUNTRIES 15 (1982) [hereinafter VAT].

[19] *See infra* notes 36–39 and accompanying text.

[20] VAT, *supra* note 18, at 15.

[21] *See supra*, note 19 and accompanying text.

Most of the nations of the EEC have departed from the pure model of a VAT, characterized by a flat rate constant over all items of production, by introducing differential rates and exemptions.[22] For instance, rates are lower on ordinary consumption items and higher on specialty consumption items most commonly purchased by the wealthy.[23] These rate differentials add an element of progressivity to the system. In addition, all of the EEC nations exempt certain commodities and classes of producers from any VAT whatsoever.[24] These include small businesses, financial services, health care and education.[25] From a practical perspective a producer who has been granted an exemption neither receives a credit when she purchases an item from a taxable producer, nor passes a credit on to any taxable buyer who purchases her product.[26] These exemptions can act simply to ease the administrative burden on the taxpayer and the system. Both exemptions and differentials represent tax expenditure items to the extent that the taxing authority is not taxing at its fullest power, and this loss in revenue can be viewed as a subsidy to the benefited classes of consumers and producers.

To summarize: under the VAT, the producer is taxed at every stage in the production process in which value is added. The tax is ultimately passed on to the consumer. As we shall see in the discussion below, the VAT system has had to adapt to the multinational characteristics of the EEC.

IV. PROBLEMS AND THEIR SOLUTIONS UNDER THE VAT SYSTEM

The VAT system as it has developed in Western Europe reflects the peculiar characteristics of the multinational structure known as the EEC. We have already seen that while imports into the nations of the EEC bear a value-added tax, a VAT credit is received by an EEC exporter for accrued VAT.[27] Case law under the European Court has had to impose flexibility on the VAT system to offset intra-EEC conflicts particularly with respect to transnational economic transactions.

In *Gunter Berkholz v. Finanzamt Hamburg-Mitte-Alstadt*,[28] a gaming machine installation and repair company with registered offices in West Germany sought to limit the West German tax on its services, which were conducted on board a ferry sailing between Germany and Denmark, to the extent that such services

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[22] VAT, *supra* note 18, at 16.
[23] *Id.*
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *See supra*, notes 19–21 and accompanying text.
[28] Case No. 168/84, CCH ¶ 14,223, 16,353.

were conducted in West German waters.[29] The European Court held that unless it could be shown that the plaintiff had some nexus of business operations on board the ferry, the place where its business was registered controlled for VAT assignment purposes.[30] In a more fundamental example of this same problem, the European Court held that a steamship line which sailed from an Italian port into international waters and then landed at another Italian port was subject to Italian VAT for the entirety of its trip.[31] In both of these cases, the court effectively ignored the fact that value was being added outside of the taxing authorities' physical jurisdiction.

Another conflict particular to the VAT system deals with transactions between an exempt consumer and a VAT-taxable seller. Assume, for example, the common transaction in which a used car dealer accepts as a trade-in a used car from a nontaxable consumer, ultimately intending to resell the car. Since the consumer is tax exempt,[32] the dealer-purchaser does not receive a credit representing the VAT already paid on the commodity in order to offset the VAT he will have to pay on resale. This results in a double tax. In fact, the Netherlands and Ireland have provisions which permit the taxable purchaser, for tax purposes, to reduce the price at which he sells a new item to the nontaxable seller by the value of the trade-in he accepted from that seller, thus lowering the VAT to be paid on the new item.[33] The practical effect of this mechanism is to give the taxable purchaser an imputed credit, i.e., a credit as if the nontaxable seller had paid VAT on the transaction. The EEC contested the legality of these provisions, arguing that a more proper mechanism would be to have the taxable purchaser, on resale of the used commodity, deduct the VAT that would have been owed by the nontaxable seller upon the acquisition of the used commodity by the taxable purchaser.[34] The court held in both of these cases that although the mechanism was different, the outcome was the same, and thus the procedure used fell within the discretion of the member states.[35]

In a related case, the Dutch buyer of a secondhand boat purchased from a nontaxable French citizen challenged the imposition by the Netherlands of a substantial VAT upon importation of the boat.[36] The European Court stated

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[29] *Id.* at 16,355.

[30] *Id.* at 16,357–8.

[31] Trans Tirreno Express S.p.A. v. Ufficio Provinciale I.V.A., Case No. 283/84, CCH ¶ 14,306, at 16,901.

[32] *See supra* text accompanying note 26.

[33] Commissioner of the European Communities v. Kingdom of the Netherlands, Case No. 16/84, CCH ¶ 14,224, at 16,362; Commissioner of the European Communities v. Ireland, Case No. 17/84, CCH ¶ 14,225, at 16,366–7.

[34] *Id.* at 16,362 and 16,366.

[35] *Id.* at 16,363 and 16,367.

[36] State Secretary for Finance v. Gaston Schul-Douane-Expediteur BV, Case No. 47/84, CCH ¶ 14,195 at 16,188.

that where a nontaxable exporter receives no refund or credit upon export, and the import is taxed, there is a double tax problem.[37] The court concluded that the VAT carried by the item must be accounted for in one of two ways. In the event the item has increased in value on resale, the amount of VAT paid which would have been paid had the transaction not been one for export must be deducted. In the event the item has decreased in value on export, the amount of VAT which would have been paid had the transaction not been one for export and a percentage representing the proportion of depreciation of the item must be deducted.[38] This removes the double taxation problem, but does not have the same policy-based effect as the mechanism in some European countries where all VAT accrued is refunded to the exporter upon export.[39]

V. CONCLUSION

This short Note does not do justice to the enormous complexity of the VAT system operating in and among the countries of the EEC. The author has sought to provide in general terms a model for the operation of the VAT and specific examples of the resolution by the European Court of problems falling between the cracks in the taxing system. In Western Europe's twenty-year experience with the VAT system, a complex and efficient taxing system has evolved to meet the peculiar needs of the transnational EEC.

Donald W. Parker

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[37] *Id.* at 16,190–91.

[38] *Id.* at 16,193. This decision was followed in G. Bergeres Becque v. Chef de Service Interregional des Douanes, Case No. 39/85, CCH ¶ 14,307, at 16,902 and 16,905.

[39] *See supra* notes 18–19 and accompanying text.