Cover Page

The handle http://hdl.handle.net/1887/29963 holds various files of this Leiden University dissertation.

Author: Bal, Aleksandra Marta
Title: Taxtation of virtual currency
Issue Date: 2014-12-02

9 Indirect tax: conclusions

9.1 Introductory remarks

Chapter Seven described the features of the model system for taxing transactions in virtual currency. Chapter Eight described the characteristics of the EU VAT and the US retail sales taxes, and applied them to trade in virtual items and currencies. Although it was focused only on two jurisdictions, the issues identified in those jurisdictions may also be encountered in a wide range of other countries around the world which are trying to find the best way to tax cross-border digital consumption in the Information Age.

This Chapter draws conclusions based on the analysis in Chapters Seven and Eight. It examines deviations from the model system, identifies best practices for digital goods[1040] and makes recommendations for the improvement of the existing tax systems. It is important to keep in mind that taxation of trade in virtual currencies and items cannot be analyzed independently of the legal environment in which the trade takes place. If this environment does not work well, it cannot provide sound background for the development of rules applicable to new phenomena, such as virtual currency. Another aspect that is worth stressing is that virtual worlds are not a law- and tax-free place. They are not an independent place with autonomous regulations, but a place subject to rules imposed by the physical non-virtual world. Transactions in virtual items represent an extreme version of electronic commerce. They are carried out anonymously by "virtual" entrepreneurs. To try to fit them into the existing VAT framework is a way to evaluate the functioning of the EU VAT rules and their potential to capture even more sophisticated (yet unknown) technological developments.

1040 The term "digital goods" is frequently used in the United States to refer to digital products, whereas such products are considered to be "electronic services" in the European Union. However, in this chapter both terms are used interchangeably.

9.2 EU VAT

9.2.1 Unclear concept of taxable person

The personal scope of the VAT system depends on the concept of taxable person, which is independent of similar concepts that may exist in commercial or civil law. Given its importance for the functioning of the VAT system and the principle of legal certainty, the definition of taxable person should be clear and unambiguous.

Reliance on vague legal concepts that must be interpreted, firstly, by the tax authorities, and, subsequently, by national courts and, in the final instance, by the ECJ, gives rise to legal uncertainty, especially when the concepts must be interpreted taking into account "all facts and circumstances of the case at hand". The outcome largely depends on the emphasis that the tax authorities and the national courts put on specific aspects of a scenario under consideration. The more aspects must be taken into account, the larger the risk of different conclusions.

Despite numerous ECJ judgments on its interpretation, the concept of taxable person continues to give rise to controversial decisions of national courts. Inconsistent case law results in uncertainty, which in turn undermines one of the most fundamental constitutional values: the predictability of law.

There is no straightforward solution to this problem. On the one hand, it is obvious that the principle of legal certainty is best served with a detailed legislation, in which clear and quantified rules are stated for clearly described series of cases.[1041] Although the US Supreme Court acknowledged in the *Quill* decision (with regard to the physical presence rule) that any bright-line tests appear artificial at their edges, the majority of the judges concluded that "this artificiality (...) is more than offset by the benefits of a clear rule". By adopting clear, bright-line rules, it was hoped to reduce litigation and to avoid confusion that might otherwise arise in the absence of "precise guides to the States in the exercise of their indispensable power of taxation".[1042]

On the other hand, in view of the variety of taxable transactions and the circumstances under which they are carried out, the adoption of additional rules for certain groups of taxpayers would complicate the VAT system to a larger extent and create classification problems. For example, special rules for online traders would have to state who may qualify as such. The more complex the system, the more administrative resources are necessary to operate it. Moreover, the use of thresholds seems to violate the principle of equity: taxpayers in very similar situations are treated differently because their turnovers are just below or just above a certain monetary amount.

1041 B. Peeters, *European Supervision on the Use of Vague and Undetermined Concepts in Tax Laws*, EC Tax Review 3 (2013).

1042 *Quill Corp. v. North Dakota*, 504 US 315 (1992).

A solution that could mitigate the characterization problem is to implement binding rulings on the status of taxable person.[1043] Taxpayers would describe their individual circumstances to the tax authorities and the latter would give their opinion on whether the activity in question is of economic nature or merely amounts to private wealth management. There should be a low-cost possibility to request such a ruling in an administrative-friendly procedure, using electronic forms and e-mail communication. Tax authorities should be obliged to respond to those requests within a predefined time limit. If the taxpayer does not receive a response in a timely manner, he should be entitled to follow the characterization specified in the ruling request (unless the circumstances described in the ruling request are incorrect or have changed).

9.2.2 Place of taxation

9.2.2.1 Initial comments

Originally, in the European Union, a commitment was taken for the introduction of a VAT system based on the origin principle. The VAT Directive still stipulates that the current arrangements for taxation of trade between Member States are transitional and should be replaced by definitive arrangements based on the taxation of goods and services in the Member State of origin.[1044] However, in the meantime, new directives laying down the place-of-supply rules for certain transactions have clearly moved away from the origin principle by stipulating the place of taxation as the place where consumption occurs or where the customer is established. Taxation at destination is currently the default rule for B2B supplies. In its communication on the future of VAT, the European Commission advocated a destination-based VAT system.[1045] The EU Expert Group on Taxation of the Digital Economy is of the view that both the Commission and Member States should commit to apply the destination principle to all supplies of goods and services. As from 1 January 2015, TBE services supplied by EU taxable persons to EU final customers will be deemed

1043 The European Commission recognizes the fact that taxpayers need certainty with regard to the VAT consequences of their transactions. In June 2013, it introduced a pilot scheme under which the participating Member States provide taxable persons with an advance opinion regarding the VAT treatment of complex cross-border transactions. *See* European Commission, *Information Notice: Test Case For Private Ruling Requests Relating to Cross-Border Situations* (June 2013), available at: http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/vat-forum-note-information_en.pdf.

1044 Art. 402 of the VAT Directive.

1045 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).

to be performed where the customer has established his business, has his permanent address or usually resides.

The main benefit of taxation at destination is that VAT revenues accrue directly to the Member State of consumption, according to its domestic rates and exemptions. Its major weakness is that it relies on the overly simplistic assumption that suppliers are able to identify the location of their customers (which is required to establish the tax liability correctly) on a transaction-by-transaction basis. While this requirement is already difficult to satisfy for suppliers of traditional services, it is a major source of concern for suppliers of digital goods. The following examples illustrate what problems may arise in a digital context.

Example 1: PayPal transaction
Seller S (taxable person) supplies digital goods (for example, electronic files with movies) to buyer B. The files can be downloaded from the seller's website after making the payment. B chooses to use PayPal for transferring the consideration. This means that his credit card number, bank account number and address stay with PayPal and are not communicated to the seller. Since S has not received any proof of business status from B, he treats his customer as a private individual and should charge VAT at the rate of the customer's country. However, S cannot identify that location. Even if he asks B to provide the necessary information by filling in an online form, he has no reliable means to verify the data.

Example 2: Bitcoin transaction
Seller S (taxable person) supplies 2 bitcoins to buyer B in exchange for cash (EUR 200). B has received the bank details of the supplier to transfer EUR 200. After the payment is received, the seller sends the bitcoins to B's digital wallet. The only information he needs for that purpose is the buyer's bitcoin address: for example, 31uEbMgunupShBVTewXjtqbBv5MndwfXhb. Such an address can be generated at no cost by any bitcoin user (this does not require any registration with the Bitcoin network) and operates in a similar way to an email address. S faces the same identification problems as in the example above.

Another problem with taxation at destination is that digital goods do not cross borders in a physical sense and are generally difficult to track. Tax administrators in the jurisdiction of destination may not know about taxable supplies made in their territory.

9.2.2.2 *Identification of customer location*

The VAT Implementing Regulation intends to assist suppliers in determining the permanent address or usual residence of the customer by establishing a number of rebuttable presumptions. For example, if for the provision of electronic 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. 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.

However, instead of assisting suppliers, the presumptions make the situation even more uncertain and complex. How the supplier of electronic services should know that the customer is using them at a Wi-Fi hotspot or how should he find out the country code of the SIM card? Many digital products can be accessed via the browser from any place as long as the Internet connection is available. Does it mean that a customer that uses electronic services in various countries and also while travelling is deemed to have his permanent address in various countries?

Another worrying fact is that the presumptions also apply to B2B services. Thus, an electronic service received by a taxable person at the Wi-Fi hotspot is deemed to be supplied at that hotspot. This clearly contradicts the wording of the VAT Directive according to which such a service is deemed to be supplied where the customer has established its business and not where the service is used and enjoyed.

If none of the rebuttable presumptions is applicable, the location of the customer must be established on the basis of two items of non-contradictory evidence (shipping address, bank details, IP address or any other commercially relevant information).The use of the evidence rule suggested by the VAT Implementing Regulation may encounter significant difficulty.

First, as digital goods are not sent on a physical carrier to the customer, there is no need to provide any shipment address which could be used as a proxy for the place of establishment, permanent address or usual residence.

Second, a country of the bank in which the buyer holds his account may have nothing to do with the place of establishment, permanent address or usual residence. A person may have accounts in various countries. Which one is used for a particular transaction depends on many factors (form of payment, transaction currency and account balance at that moment). Moreover, bank details are not disclosed to the other party in transactions handled by payment intermediaries, such as PayPal.

Third, the customer's IP address is a way to identify the computer used to perform a particular transaction, but not necessarily the person involved in it. With regard to the storage of IP addresses, the EU policy on personal data protection must be taken into account. The purpose of these EU rules is to protect the fundamental rights and freedoms of natural persons and, in particular, their right to privacy with regard to the processing of personal data.

Under Directive 95/46/EC, personal data means any information relating to an identified or identifiable natural person.[1046]

Opinion 4/2007 of the Article 29 Working Party[1047] clarifies how the concept of personal data applies to IP addresses.[1048] The Working Party noted that there are cases in which IP addresses do not allow the identification of users for various technical and organizational reasons. One example could be an IP addresses attributed to a computer in an Internet café, where no identification of the customers is requested. Although it can be argued that the data collected on the use of computer X during a certain timeframe in an Internet café does not allow identification of the user, it should be noted that the Internet service providers usually do not know whether the IP address in question is one allowing the identification or not and that they process data associated with that IP in the same way as they treat information associated with IP addresses of users that are duly registered and are identifiable. The Working Party acknowledged that, in most cases, IP addresses are data relating to an identifiable person. Thus, unless the Internet service provider is in a position to distinguish with absolute certainty that the data corresponds to users that cannot be identified, it has to treat all IP information as personal data to be on the safe side.

Under article 6 of Directive 2002/58/EC,[1049] data relating to users of electronic communication networks must be erased or made anonymous when it is no longer needed for the purpose of the transmission of a communication. Such data may be stored for billing purposes only for a limited time. The Working Party considers a period of maximum three to six months as appropriate (with the exception of cases of disputes, for example, when the bill is

---

1046 Art. 2a of *Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the Protection of Individuals with regard to the Processing of Personal Data and on the Free movement of such Data*, OJ L 281 of 23 Nov. 1995. The term "identifiable" is clarified in recital 26 of that Directive, which states that "to determine whether a person is identifiable, account should be taken of all the means likely reasonably to be used either by the controller or by any other person to identify the said person." This means that a mere hypothetical possibility to identify the individual is not enough to consider the person to be "identifiable". If, taking into account "all the means likely reasonably to be used by the controller or any other person", that possibility does not exist or is negligible, the person should not be considered "identifiable", and the information should not be regarded as "personal data".

1047 The Article 29 Data Protection Working Party was set up under Directive 95/46/EC. It has advisory status and acts independently. *See* http://ec.europa.eu/justice/dathey are ta-protection/article-29/index_en.htm.

1048 Opinion 4/2007 on the Concept of Personal Data, 01248/07 WP 136.

1049 *Directive 2002/58/EC of the European Parliament and of the Council of 12 July 2002 Concerning the Processing of Personal Data and the Protection of Privacy in the Electronic Communications Sector (Directive on Privacy and Electronic Communications)*, OJ L 201 of 31 July 2002. The Directive on Privacy and Electronic Communications translates the provisions of Directive 95/46/EC into specific rules for the electronic communication sector.

contested).[1050] The stored traffic data must be limited to the necessary one. It is not allowed to store data that are irrelevant to either billing or interconnection payments.[1051]

To sum up, under EU law, IP addresses are considered to be personal data, and, as such, they cannot be freely communicated. They can only be legally gathered under strict conditions and for a legitimate purpose. Persons or organisations which collect and manage them must protect them from misuse and must respect the rights of the data owners.

Another problem related to the information value of IP addresses is that anyone can hide their location. So-called "anonymizer" sites hide the origin of communications over the Internet. There are two basic types of Internet anonymizers: networked and single-point.[1052] Networked anonymizers transfer data through a network of computers until it reaches its destination. For example, a request to visit a webpage might first go through computers A, B, and C before going to the website, with the resulting page transferred back though C, B, and A. The main advantage of the networked anonymizer is that it makes traffic analysis much more difficult. To mitigate the risk of traffic analysis, such anonymizers can: add small but random delays to the passage of responses back to the user to make time matching more difficult, make random requests to random pages across the web to pollute the pool or have a large cache of web pages so not all incoming requests have outgoing requests. Single-point anonymizers pass data through a single website to protect the user's identify and often offer an encrypted communications channel for passage of results back to the user. They offer less resistance to sophisticated traffic analysis than do networked ones. Many single-point anonymizers create an anonymized URL by appending the name of the site the user wishes to access to their URL.

The evidence rule suggests verification sources which are quite often unavailable to the suppliers. The problems identified above (lack of shipping address, the use of payment intermediaries, and legal and practical obstacles related to the identification and storage of IP addresses) mean that suppliers of electronic services will have to rely on information provided by the customer

---

1050 Opinion 1/2003 on the Storage of Traffic Data for Billing Purposes, 12054/02/EN WP69.

1051 The Directive on Privacy and Electronic Communications was amended by the Data Retention Directive (*Directive 2006/24/EC of the European Parliament and of the Council of 15 March 2006 on the Retention of Data Generated or Processed in Connection with the Provision of Publicly Available Electronic Communications Services or of Public Communications Networks and Amending Directive 2002/58/EC*, OJ L 105/54 (2006)). The amendments oblige Internet service providers to retain personal data, such as the identity of a user of an IP address, for a period of between six months and two years. The aim is to ensure that the data retained is available for the purpose of the investigation, detection and prosecution of serious crime, as defined by each Member State in its domestic law. However, the ECJ ruled that the Data Retention Directive is invalid. *See* ECJ, 8 Apr. 2014, Joined Cases C-293/12 and C-594/12, *Digital Rights Ireland and Seitlinger and Others*.

1052 *See* http://www.livinginternet.com/i/is_anon_work.htm.

without having any means to verify it. It is unclear what should be done if two non-contradictory pieces of evidence cannot be found. The Explanatory Notes simply recommend that the suppliers "continue to seek" them.[1053]

Another element that should not be underestimated is the average sales price of digital products and the high number of daily transactions. Many digital goods are cheap and they can be easily and fast moved across the globe. This means that imposing transaction-based verifications is likely to cause costs equal to or even exceeding the benefit of most online transactions.

Moreover, the evidence items prescribed in the VAT Implementing Regulation can be easily manipulated. Customers can open a bank account in a third country or a country with a low VAT rate, and claim to be resident there. It is also unclear why a country of the bank account or a country that issues a SIM card is used to determine the place of supply since such countries may have no relationship with the country where the customer has a permanent address or usually resides.

9.2.2.3 One Stop Shop regime

The (Mini) One Stop Shop arrangement was introduced to avoid multiple registration and reporting obligations. While it clearly reduces the compliance burden, its operation is not free from flaws. First, it results in a cash-flow disadvantage as suppliers must always remit VAT upon submission of their VAT returns, whereas input VAT cannot be immediately deducted, but its refund must be requested under the provisions of the Thirteenth VAT Directive (third-country suppliers) or Directive 2008/9 (EU suppliers). Second, it does not relieve suppliers from the burden of locating their customers on a transaction-by-transaction basis. Third, suppliers must comply with VAT legislation of the Member States where their non-taxable customers are resident in all circumstances. Unlike in the case of supplies of goods under the distance selling regime,[1054] there is no turnover threshold for supplies of cross-border electronic services: even if the volume of such services supplied in a particular Member State is insignificant, the service provider must be aware of the local VAT legislation. Although the VAT rules are harmonized across the European Union, Member States still have discretion with regard to the application of certain provisions. For example, Member States may decide about granting bad debt relief (i.e. the reduction of the initial VAT liability in the case of non-payment by the customer) and determine the conditions that need to be fulfilled for that purpose.[1055]

Enforcing the One Stop Shop regime is difficult in a digital context where multiple transactions are carried out anonymously. Tax authorities have limited

1053 *Explanatory Notes*, *supra* n. 899, at sec. 9.5.7.
1054 Art. 34 of the VAT Directive.
1055 Art. 90 of the VAT Directive.

possibilities to sanction third-country suppliers who fail to register and report their supplies to EU customers.[1056] According to statistics provided by the UK Treasury in March 2012, 453 non-EU providers of electronic services had registered under the One Stop Shop scheme at the end of 2011 (207 in the United Kingdom, 83 in the Netherlands, 65 in Luxembourg, 36 in Germany, 25 in Ireland, 14 in Italy and 23 in nine other Member States).[1057] It is questionable whether the fact that VAT collection in third-country scenarios is reliant on voluntary compliance by non-EU suppliers is acceptable for EU suppliers and Member States' budgets from a neutrality and competition perspective in the long term. Without effective supervision and enforcement, there is a risk of non-taxation that threatens to distort competition. If tax rules are not linked to a real possibility of enforcement, taxpayers are unlikely to comply.

The MOSS and OSS will not provide simplification and relieve suppliers from the obligation to register in multiple countries in all situations. Non-EU suppliers of electronic services 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) cannot be registered under the OSS. Article 358a of the VAT Directive defines a non-EU taxable person as a person that does not have a place of establishment or a fixed establishment in the EU territory and that is not otherwise required to be identified for VAT purposes in the European Union. Neither can such suppliers be registered under the MOSS since only taxable persons that are established or have a fixed establishment in the European Union can benefit from this scheme.[1058]

Another example of how the MOSS will makes the compliance obligations of suppliers more complex is as follows. A UK supplier provides electronic services to final consumers (B2C transactions) resident both in the United Kingdom and in other Member States. His turnover from taxable transactions has never exceeded GBP 81,000 (the UK registration threshold) and it not likely to do so in the future. A large portion of the turnover (GBP 60,000) comes from transactions with UK customers, whereas only GBP 10,000 from the cross-border provision of services. Until 31 December 2014, all supplies of electronic services are deemed to be made in the United Kingdom and the supplier does not have to register for VAT purposes. However, as from 1 January 2015, the supplier will have to register since the GBP 10,000 services will be deemed to be supplied in other Member States.

1056 Van Kesteren mentions the enforcement problem as the main weakness of the One Stop Shop regime. *See* H. van Kesteren, *Society's Online Revolution and the Short Arms of the Tax Authorities* in: *VAT in an EU and International Perspective* (H. Van Arendonk, S. Jansen & R. Van der Paard eds. IBFD 2011), Online Books IBFD.

1057 Those statistics are cited in M. Lamensch, *Proposal for Implementing the EU One-Stop-Shop Scheme from 2015*, 23 Intl. VAT Monitor 5 (2012).

1058 Art. 369a of the VAT Directive.

9.2.2.4 Recommendations

The application of the place-of-supply rules places a heavy compliance burden on suppliers. Although the destination principle is the theoretically correct way to tax consumption, to ensure neutrality and to create a level playing field for supplies of electronic services, the difficulty of its practical application should not be underestimated. First, instead of applying their familiar domestic VAT law, suppliers will have to be aware of the relevant VAT legislation of other Member States. Thus, service providers having customers in 28 Member States will have to comply with 28 national VAT laws, irrespective of their sales volume in those countries. Second, the location of their customer is not easy to identify when services are provided at a distance, payment intermediaries are involved and no physical shipments take place. Third, although the OSS and MOSS aim to provide simplification, their operation is not free from flaws.

One of the solutions to the identification and remittance burden currently discussed in the European Union is the real-time VAT (RTVAT).[1059] The RTVAT project suggests eliminating the possibility for suppliers to receive VAT from their customers by organizing the tax collection at the level of the banks. The supplier would receive the VAT-exclusive price and the VAT would automatically be remitted to the competent tax authorities by the customers' banks. A software program would calculate the applicable amount of VAT based on the status and location of the customer which would have to be disclosed to the bank at the time of the opening of the account. RTVAT imposes the tax collection obligation on a party that has the means and technical expertise to comply with law and that has benefited from the growth in electronic commerce. Payment intermediaries are not small companies that would be adversely affected by processing transactions. However, although RTVAT collection fixes all the weak points of the current VAT system, it makes very high demands on both the technical payment infrastructure and the cooperation between financial institutions and tax authorities. It would require enormous implementation costs and, to be effective, it would have to be implemented by all the financial institutions. The software would have to be able to apply correctly exemptions or reduced rates that vary from country to country. The question also arises how a bank can determine the correct VAT amount without interfering with the supplier's liability. Moreover, the operation of an EU-wide database that gives access to business records of millions of companies would raise privacy issues. An electronic system involving banks, suppliers and credit

---

1059 B. Wohlfahrt, *The Future of the European VAT System*, 22 Intl. VAT Mon. 6, sec. 3.3.1 (2011); R.T. Ainsworth, *Technology Can Solve MTIC Fraud – VLN, RTvat, D-VAT certification*, 22 Intl. VAT Mon. 3 (2011); C. Williams, *Technology Can Solve MTIC Fraud – 2*, 22 Intl. VAT Mon. 4 (2011); R.T. Ainsworth, *Technology Can Solve MTIC Fraud – 3 and Final*, 22 Intl. VAT Mon. 4 (2011).

companies would be a target of hacker attacks. Thus, it is not likely that RTVAT collection will be implemented.

As shown above, the application of the destination principle gives rise to uncertainty and a heavy compliance burden, which are absent when digital goods are taxed at origin. Under the origin approach, suppliers assess and collect VAT in accordance with their local legislation. Moreover, they only have to satisfy administrative formalities required by their own tax authorities. However, the origin principle was rejected by the European Commission for the following reasons. First, origin-based taxation would make it necessary to harmonize the VAT rates to prevent rate differences from influencing decisions on where to buy and to locate business activity.[1060] Second, a clearing system would be needed to ensure that VAT receipts accrue to the Member State of consumption. Third, Member States would have to rely on each other to collect a substantial part of their VAT revenue.[1061] As destination-based taxes can be avoided only by changing the place of consumption, which generally means changing the place of residence, they do not give rise to serious competition issues. Consumers have little inclination to change their location only to benefit from a lower VAT rate. Thus, differences in destination-based taxes are not likely to distort decisions of where to live and consume.[1062]

In my view, the compliance burden placed upon suppliers of cross-border electronic services would be relieved if an option to apply the origin principle to such supplies was available as a method of last resort, i.e. in circumstances in which no information on the permanent address or the usual residence of the customer based on the evidence rule could be obtained.[1063] Such a rule would eliminate suppliers' potential liability for an incorrect determination of the customer's location. If it is impossible to identify the customer's location, the supplier should be allowed to charge VAT in accordance with his own domestic legislation. To prevent abuse, the application of the origin option should only be possible upon prior authorization by the tax authorities. The permission should not be required for individual transactions, but it should be granted for a certain period to taxable persons whose type of business activity does not allow the implementation of sophisticated verification systems. Taxation according to the origin principle in a limited number of cases would be less distortive than non-taxation resulting from the application of the destination principle (non-taxation occurs if the customer pretends to be

---

1060 Under the place of supply rules applicable to supplies to private individuals until 31 December 2014, there is a clear incentive to provide digital products from Luxembourg, which has the lowest VAT rate in the European Union (15%).

1061 European Commission, *Green Paper on the Future of VAT: Towards a Simpler, More Robust and Efficient VAT System*, sec. 4, COM(2010) 695 final (1 Dec. 2010).

1062 C.E. McLure Jr., *Tax Competition in a Digital World*, 57 Bull. Intl. Fisc. Doc. 4, sec. 2.1, (2003).

1063 The application of the origin principle as a method of last resort is allowed in the United States under the SSUTA. *See* section 8.2.3.3. *Place of taxation*.

resident in a third country and the supplier has no means to verify this). It would make the tax system workable and would not punish businesses which have chosen certain distribution channels by placing on them too burdensome and difficult to fulfil compliance obligations.

As One Stop Shop regimes based on voluntary compliance are not effective, the enforcement of taxes on the consumption of digital goods should be given more attention in international agreements on cooperation in tax matters. EU Tax Commissioner Algirdas Šemeta has stressed the importance of international cooperation and the willingness of the European Union to cooperate:[1064]

> 'There is no effective way of ensuring compliance if a business located in California, for example, provides e-services to a private individual in Slovakia and does not register for the e-commerce scheme and pay Slovak VAT. What can the national tax authorities do realistically? The Commission is addressing this issue and has asked member states for a mandate to negotiate with third countries on this issue from a collective position of power. For the time being, though, compliance depends on the willingness of suppliers in third countries to assume their legal obligations.'

The final report of the EU Expert Group on Taxation of the Digital Economy[1065] suggested that tax treaty provisions should be extended to include consumption taxes and that the OECD Model should be amended accordingly. From an EU perspective, the most effective solution would be an agreement between the European Union and a third country that would solve the problems of non-taxation or double taxation of transactions. The Group also considered that consumption taxes should be included in exchange-of-information clauses in tax treaties.

However, to be able to exchange information or request assistance, tax authorities must first be in possession of the relevant information. The fact that a non-EU entrepreneur supplies digital goods to EU customers can be detected by his local tax authorities during a tax audit or by extracting data from trading platforms. One of the ways to monitor transactions on trading platforms is the use of sophisticated web crawling programs.[1066] Special software crawls through the websites and captures data necessary to identify sellers which is later cross-referenced with other databases and tax records. For example, German tax authorities use XPIDER, a software robot extracting information about sellers with high turnover from platforms, such as eBay.[1067] The Xenon Spider Software, developed for the Dutch tax authorities,

1064 A. Šemeta, *The Mini-One Stop Shop for VAT – The Start of Something Big*! (2012), available at: www.worldcommercereview.com/publications/article_pdf/617.

1065 Expert Group on Taxation of the Digital Economy, *supra* n. 20, at sec. 4.2.5.

1066 Both more extensive administrative cooperation in cross-border tax matters and the use of web-based robots are also suggested by Van Kesteren, *supra* n. 1056, at sec. 5.

1067 *XPIDER – der virtuelle Jäger der Steuerfahndung*, available at http://www.onlinesteuerrecht.de/home/index.php?option=com_content&task=view&id=231&Itemid=33.

has been successfully applied in Canada, the United Kingdom, Austria and Denmark.[1068]

Internet trading platforms are frequently requested to disclose to the tax authorities data on sellers whose turnover exceeds certain thresholds. In May 2013, the German Federal Tax Court (*Bundesfinanzhof*) ruled on the legality of information requests concerning unidentified taxpayers.[1069] The facts of the case were as follows: a Germany company operating a trading platform transferred this business activity to its Luxembourg affiliated company. After the transfer, it continued to provide data-processing services to that affiliate. The German tax authorities ordered the German company to provide them with the names and addresses of sellers whose turnover from sales on that platform exceeded EUR 17,500. The company claimed that it was impossible to provide the requested information: the relevant data was stored on servers abroad (so the company could not access it) and the agreement between the two affiliates did not permit data disclosure to third parties. The Tax Court of Lower Saxony (*Finanzgericht Niedersachsen*) followed the company's reasoning. However, the Federal Tax Court annulled the decision of the lower instance and ordered the Tax Court of Lower Saxony to establish whether the German company had a real possibility to obtain the data (the non-disclosure clause in the intercompany agreement should be disregarded) and whether tax evaders were likely to be detected as a result of the enquiry (the mere possibility of tax evasion does not entitle tax authorities to request information on unidentified taxpayers).

Information requests are likely to be successful if they are targeted at resident companies since non-compliance with such requests can trigger immediate sanctions. However, tax authorities have limited or no possibilities to obtain information from foreign companies if their efforts are not supported by the foreign tax administration. Without administrative assistance in tax matters, the destination principle cannot be effectively applied.

9.2.3 Exemptions

Another solution to problems caused by virtual currencies would be to introduce an (optional) exemption for digital barter. The EU VAT system applies exemptions to a wide range of activities which are said to be difficult to tax (financial and insurance services and gambling). There seems to be no scholarly argument that supports exemption for those activities, except the one that accurately calculating the tax base is too complicated (for example, in the case of gambling, under the credit-invoice method, casinos would be required to

1068 *Zoekrobot Belastingdienst wereldwijd success* (2007), available at https://www.security.nl/posting/15305/Zoekrobot+Belastingdienst+wereldwijd+succes.

1069 BFH, 16 May 2013, II R 15/12.

report the bets as outputs and the winning paid out as inputs on a transaction-by-transaction basis). Preparatory work to the Sixth Directive confirms this reasoning.[1070]

However, the benefits of maintaining exemptions in the VAT system are questionable.[1071] Form a legal perspective, exemptions give rise to definitional and interpretative problems, and make it necessary to calculate the proportion of deductible input VAT. Taxpayers who sell both taxable and exempt outputs are faced with complex tax calculations. Thus, from the perspective of legal certainty and simplicity, the introduction of exemptions for digital barter transactions is not desirable.

9.3 US Sales Tax

9.3.1 Uniform treatment of digital goods

At present, the scope and rates of sales taxes vary from state to state. The states have taken different approaches to defining and taxing digital goods: they tax them in the same way as tangible property, do not tax them at all or have enacted special rules that apply to electronically transferred products. All this gives rise to competitive inequalities and violates the principle of neutrality and equity. Distinctions are made that neither have economic sense nor serve any useful purpose. Sales taxes discriminate the goods and few services that are subject to them in favour of the large sectors of the economy that remain untaxed. There is no rational reason for the way different goods and services are currently treated under sales tax law and for the fact that tax policy favours content delivered online over that in tangible forms.[1072]

The failure to tax all consumption complicates compliance and administration, and leads to loss of revenue or to higher income and sales tax rates for supplies that do not escape taxation. The existing laws (with multiple definitions, exemptions, rates, registration, filing and audit procedures) fail to satisfy the principle of simplicity and certainty. They are also the main obstacle to the taxation of interstate trade: it is unreasonable to expect remote sellers to determine sales and use tax liability for each of the 7,500 taxing jurisdictions with different definitions of tax base and exemptions ("a virtual welter of complicated obligations").

1070 European Commission, *Proposal for a Sixth VAT Directive on the Harmonization of Legislation of Member States Concerning Turnover Taxes – Common System of Value Added Tax: Uniform Basis of Assessment*, COM(73) 95 (20 June 1975).

1071 *See also* section 7.5.3.2. *Equity*.

1072 It is interesting to observe that the European Union applies higher tax rates to digital goods (books) than to their equivalents in printed form, whereas digital goods are treated more favourably than their printed counterparts in the United States.

While it is clear that a complete uniformity in state sales taxation is not likely to be achieved, the states should adopt one set of the basic rules (definitions of taxable events and sourcing rules) and interpret them consistently. To be able to pursue their own fiscal policy and to control the revenue-raising potential of their sales taxes, the states could remain competent to determine their own tax rates. Such a system would resemble that of the European Union where the Member States are bound by common rules on the taxable transactions but are free to set their own VAT rates within the predefined framework.

As the principle of neutrality requires all consumption to be taxed, digital goods should generally be included in the RST scope. All products delivered electronically, irrespective of whether on the basis of a sales, lease or rental transaction, should be subject to tax. No exemption should apply to electronically transferred products since, from a tax policy point of view, no reasons for such an exemption can be found.

9.3.2 Nexus and interstate trade

Currently, the scope of sales taxes is limited to domestic sales. Since interstate commerce is the exclusive domain of the federal government, the states have no authority over out-of-state suppliers, unless those suppliers have sufficient nexus with the state. In respect of cross-border transactions, use taxes should be applied. However, they have proved to be very ineffective since consumers do not have any incentive to remit the tax or are not aware that such an obligation exists at all. In the European Union, reverse charging has never been considered as an option for taxing B2C supplies.

Congress does not consider that remote sellers ought to be placed in a tax-advantaged position as compared to local retailers. Rather, it is afraid that ″variations in rates of tax, in allowable exemptions, and in administrative and recordkeeping requirements“ could create ″a virtual welter of complicated obligations“ for taxpayers engaged in interstate business. Thus, based on the Commerce Clause, states will not be allowed to collect use taxes from out-of-state sellers until they simplify their sales tax laws.

While the nexus rules provided in *Quill* reduce complexity, they are a highly defective way to deal with avoidable complexity. These rules are unfair to local merchants since they distort commerce: not by impeding interstate trade but by favouring it at the expense of intrastate commerce. The *Quill*'s bright-line presence test makes no economic sense. The current situation violates the principle of neutrality since supplies escape taxation when the seller lacks physical presence in the state. As consumers ordinarily do not remit use tax on purchases from remote sellers despite the legal obligation to do so, a *de facto* exemption of B2C remote sales exists.

Even if states, acting in concert, simplified their sales tax laws, only Congress or the Supreme Court could eliminate the physical presence test. In other

words, the states could create the preconditions for a reform, but Congress or the Supreme Court must implement it. It is unfeasible for the Supreme Court to overturn its earlier decisions without a serious progress by a large number, if not all, of the states in respect of harmonization and simplification of their sales and use tax systems. All these developments clearly point out that a solution can only be found at the level of federal legislation. The Supreme Court emphasized in *Quill* that Congress remained constitutionally free to "overrule" the judgment.

A new nexus standard should be established on the basis of the seller's economic rather than legal or physical contacts with a state. Such a nexus could be deemed to exist if the seller's turnover exceeded a certain threshold. With regard to the threshold, there are two options: nexus could be based on aggregate sales in all other states or on the sales volume in a particular state. The former has many disadvantages. It would create an enormous burden for sellers whose sales exceed the threshold, since they would have nexus in all states, irrespective of their sales volume there. It would discourage businesses with sales above the threshold from making any sales to a state where the benefits would not justify the compliance costs. Finally, it would prevent a state from asserting nexus over a vendor making substantial sales in its market as long as the seller's total out-of-state sales fell below the nationwide threshold.[1073] Thus, the turnover threshold should be based on the sales volume in a particular state. This approach is economically sensible and clear. It would render irrelevant issues such as whether placing advertisement on a website constitutes nexus. The turnover threshold would relieve sellers who derive negligible revenue from certain states from the obligation to comply with the local rules.[1074]

Another solution would be to abolish the nexus standard completely. If uniform definitions of taxable transactions were used in all the states, the sellers would only have to determine the correct RST rate. This should not be a difficult task given that the sellers can benefit from software solutions recommended by the SSUTA and Market Fairness Act 2013. Such certified software can be used not only to calculate sales and use taxes due on each transaction but also to file the relevant tax returns.[1075]

1073 McLure, *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints and Tax Laws*, *supra* n. 21, at p. 400.

1074 Similar rules apply to distance sales in the European Union. When a supplier delivers goods to private individuals in other Member States, he must charge VAT applicable in the Member State where his customer is resident unless the total value of the goods supplied to private individuals in that particular Member State remains below an annual threshold set by that State (art. 34 of the VAT Directive).

1075 The new place-of-supply rules applicable to electronic services as from 1 January 2015 require that supplies of such services to private individuals in other Member States be taxed at destination, irrespective of the value of the services supplied in a particular Member State (no thresholds will apply). *See* section 8.1.4. *Place of taxation*.

9.3.3 Place of taxation

The RST place-of-supply rules vary from state to state. The Streamlined Sales Tax Project prescribes a hierarchy of sourcing rules depending on information that is available to sellers: taxation should follow the destination principle, but if the seller cannot determine the place of consumption, origin-based taxation may apply.

The destination principle remains the conceptually ideal approach to taxing consumption. It does not differentiate between expenditure on goods imported or locally produced. The total amount of tax collected is not influenced by the geographical structure of the value chain. Thus, the primacy of the destination principle incorporated into the SSUTA should be adopted nationwide. On the other hand, destination-based taxation may be difficult to apply in a digital context or vulnerable to manipulation. Customers operating in many states could select those that do not tax digital products and assert that those are the locations where the products will be used. It seems that the same approach as that recommended for the EU VAT system could strike the necessary balance between the desire to ensure similar rules for taxation of all consumption in a particular jurisdiction and the need to take into account suppliers' compliance burden. Under this approach, the default rule would be taxation at destination; however if suppliers cannot determine the customer's location based on various proxies (for example, bank details or shipping address), they should apply their local sales tax (taxation at origin).

9.3.4 Reform

Uniformity in consumption taxation seems to be more easily achieved in the European Union than in the United States. While the VAT Directive allows Member States some latitude in defining their tax bases, that latitude is nowhere as great as that found in the sales taxes. This development is easy to explain: at the time the European Community was created, it had only six Member States. As other countries joined, they were required to levy VAT based on the Sixth Directive and its successors. By comparison, the US states were already there when the first sales tax was levied. The EU Member States chose to limit their fiscal sovereignty in the field of indirect taxation at the outset in order to create conditions for the establishment of a single market. The VAT imposed in the European Union is a result of rational design and politics (especially in the case of exemptions and differential rates). The system was explicitly chosen to avoid the distortions inherent in the turnover taxes that preceded it. By comparison, in the United States, fiscal sovereignty has prevailed over uniformity. The US sales taxes "just grew" with little purpose or

design other than to raise revenue. Each state went its own way with no efforts at coordination until the past few years.[1076]

Taxing transactions in virtual currencies would not be a good idea if adopted in the current system. Under this scenario, states would presumably extend their existing sales taxes to digital goods with all the inequalities and distortions that the sales tax system entails. Compliance and administrative problems for interstate trade would be created. The US sales tax system lacks almost all the characteristics of an optimal tax system. It is plagued by a number of problems, the most important of which are: a *de facto* exemption for interstate trade, lack of uniformity in the definitions of taxable events, prevailing non-taxation of digital goods, and different sourcing rules among the states. Thus, there seems to be no good alternative other than a reform of the existing system of sales and use taxation.

Discussions about tax reform occur in the Unites States on a regular basis, both in academic circles and at the political level.[1077] The most radical alternative would be to replace the current system with VAT, which accomplishes many objectives of consumption taxation. A federal consumption tax could be used to obtain sufficient revenue to repay the rapidly increasing national debt and bailouts for failing financial institutions and industries. It would also decrease the reliance on income tax. The fact that all sales (both to businesses and to consumers) would be taxed would simplify compliance and administration.

However, there are serious political obstacles to the introduction of a federal VAT. VAT is unpopular among politicians since due to its regressive nature it burdens low-income households (i.e. it takes a higher percentage of the income of the poor than of those in higher income groups). Some states and local governments see the enactment of a federal VAT as an unwelcome encroachment on their fiscal sovereignty. The existence of both state and federal consumption taxes would also present challenges of coordination.[1078] As the introduction of a federal VAT system is not likely to occur in the near future, an attempt needs to be made to rationalize the current system without abandoning it completely. Despite many objections to sales taxes, it seems certain that they will remain a primary component of state and local tax revenues.

1076 C.E. McLure Jr., *EU and US Sales Taxes in the Digital Age: A comparative Analysis*, 56 Bull. Intl. Fisc. Doc. 4, sec. 6.2. (2002).

1077 *See* Tax Analysts, *The VAT Reader: What would a Federal consumption Tax Mean for America?* (2011); McLure & Merrill, *supra* n. 994; C.E. McLure, Jr., *How to Coordinate State and Local Sales Taxes with a Federal Value-Added Tax*, 63 Tax L. Rev. 3, p. 639 (2010); R.G. Penner, *Do We Need A VAT to Solve Our Long-Run Budget Problems?* 63 Tax L. Rev. 2, p. 301 (2010).

1078 McLure & Merrill, *supra* n. 994, at sec. 2.3. However, Canada has shown that a federal VAT can coexist with consumption taxes at the provincial level.

9.4 CONCLUSIONS

The Information Age has placed strains on consumption taxes throughout the world. The EU VAT system seems to have kept pace with these far-reaching changes and developed quite effective ways of taxing digital goods. The EU VAT meets many of the criteria of the model tax system. It covers all consumption, employs the destination principle and relieves businesses from the VAT burden. Its weak points are: an unclear concept of the taxable person and high compliance burden resulting from the application of the destination principle. However, those problems could be remedied by implementing taxpayer-friendly binding rulings and a possibility to switch to the origin principle as a last resort. Although the legal setting for the consumption taxation in the European Union is very different from that in the United States, many features of the EU VAT system (for example, comprehensive and uniform definition of taxable transactions) can be used as guidelines to modify the sales tax systems.

The state sales tax systems inherited from the Industrial Age do not operate well in the Information Age, a world where economic activity transcends state boundaries. States have not accommodated their tax systems to this new reality. Their inability to tax electronic commerce has been causing significant revenue losses. State sales tax systems fall short of implementing the destination principle and exempt the consumption of digital goods from taxation by excluding those goods from the tax scope and by *de facto* exempting interstate trade. However, the main problems faced by trade in digital goods are not new: they occur because digital goods aggravate the defects in the existing sales tax systems. These problems provide a classic example of how prior errors in tax policy cast a long shadow over current policy because of what economists call "path dependence" – the dependence of outcomes on the path history has taken.[1079]

Taxing trade in virtual currencies and items in the current US environment would aggravate the existing distortions and inequalities and create compliance problems for suppliers. As a radical departure from present practice (the introduction of VAT) is not likely to occur, it is necessary to rationalize the existing system without abandoning it completely. The most common sense approach would be to achieve uniformity in the basic legal framework by enacting federal legislation. By introducing uniform definitions of taxable transactions, uniform sourcing rules and amending the nexus standard, it is possible to create a level playing field for trade in digital goods. The more time will pass without affirmative congressional action, the longer the states go without taxing sales transactions on the Internet and the harder will it be to correct the problem. Congressional action would establish permanent

1079 McLure, *Tax Competition in a Digital World*, *supra* n. 1062 at p. 135.

boundaries for taxation of digital goods and remove uncertainty resulting from unclear and complex state rules.

Finally, it should be noted that the proposals mentioned in the previous sections with regard to both the EU VAT and US sales tax systems do not solve all the problems. However, the quest for perfection should not stand in the way of improvement.