



The Legal Framework for Harmonization of Value Added Tax (VAT) in European Union

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Abstract: This article examines legal framework for harmonization of VAT, the role and basic principles of VAT in EU. It generally describes the nature and scope of the EU VAT system and the framework of the birth of EU VAT system, including the treatment of directives (Sixth VAT Directive, 1977) and the concept of harmonization of tax system in order to achieve the objectives of integration policies. The article also considers the impact have played the harmonization of national legal system and a fundamental role in the European integration process. It concludes that removing barriers to trade between countries ensure freedom of movement the persons, goods, services and capital it seems to be a significant steps forward and a prerequisite for the creation and effective functioning of the single market. The methods used are logical, normative, synthesis, deduction and comparative analysis of directives.

Keywords: VAT; Tax System; Harmonization; EU

1. Introduction

In modern states, taxes are the main instrument for the collection of public revenues and financing public expenses and simultaneously play a key role in drafting economic and social policies. The issue of *tax harmonization* of tax systems of EEC Member States is considered a difficult issue taking into consideration differences of economic and social systems of the Member States, different concepts about taxes in general dealing with direct or indirect counter remuneration report of paid taxes and distribution of state revenues. Various authors have expressed their attitudes about the meaning of the notion

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harmonization of tax systems. Mainly, the starting point of their studies has been the differentiation of the term *harmonization* from terms: coordination, collaboration, approximation, competition, standardization, convergence etc. According to *Bénassy-Quéré, Trannoy and Wolf (2014)*, harmonization is a form of coordination in order to determine the minimum tax base and minimum tax rate. Whereas, *Tillinghast, (2000)*, tax harmonization process describes as a process with different implications that may result as unsuccessful and expresses doubts about the functioning of the harmonization of tax systems. The importance of the role that harmonization of tax systems of countries play claiming to be part of the EU *acquis*, explains the author *Arbutina (2006)*. Slovenia and Croatia's accession to the EU as harmonization process have been followed with different challenges, according to *Janezic and Babic (2004)*. Through partial harmonization of indirect taxes (value-added tax and excise duties) the EU has reached a considerable degree of fiscal neutrality (*Tyc, 2008*). A more complex study with regard to the role played by indirect taxes, in particular, VAT in the process of harmonization of tax systems is treated by the author, *De La Feria (2009)*. In the European Commission report (1980) are highlighted several components that hinder conversion issue of tax systems and their harmonization, such as:

- State Sovereignty (national) – financial/tax sovereignty (one of the main powers that national parliaments have is voting separate tax forms);
- The difficulty of eliminating inconsistencies of tax systems of member states and collection of revenues from the application of different taxes;
- Differences of member states in approximate common economic –social policies with the purpose of harmonization of tax systems;
- Increased dissatisfaction of taxpayers towards increased tax forms.

In this way, the issue of tax harmonization process appears as a complex process with its specifics of political, economic, social and technical character. Member States showed a positive will with regards to undertaking some steps towards tax harmonization systems. In agreements reached between the member states of the EU, advantages of national tax systems are specified in case of conversion and their harmonization with *the acquis*, such as:

- Free movement of persons, goods, services and capital;
- Tax neutrality within the commercial exchange;

- Fair competition;
- Elimination of fiscal –tax barriers;
- Creation of own funding sources.

Despite the importance of national taxes at the national level, taxes have their own determining importance in European Community Policies (ECC).

Therefore, in 1980, the EC report regarding the conversion of tax systems into that of the community, lists the fundamental objectives laid down by the EEC Treaty in order to achieve tax harmonization, such as:

- Establishment of a common market, where it will enable free movement of people, goods, services and capital and operation of free competition;
- Coordination of economic policies within member states;
- Institutions that will deal with common policies such as foreign trade, agriculture, transport, energy, regional policies and environment;
- Funding in the form of contributions of the member states of the community will be replaced by the Community's own sources.

Therefore, it is noted that “... the undertaken measures so far for tax harmonization will never succeed if the Community fails to act in the field of taxation.”

2. Value Added Tax by the Prospect of Harmonization with the *Acquis Communautaire*

Recently, the design of policies and tax systems has attracted the attention of taxpayers in the area of the EU and outside, taking into consideration the impact and the role of the tax system in the economic development of the state and in determining the economic position of the family economy. The tax system should be structured with the aim of promoting economic growth, free competition, employment, through which collection of revenues and funding of social welfare is achieved. (Garcia, Pabsdorf & Mihi-Ramirez, 2013). Countries claiming the candidate status and full membership in the EU, should certainly harmonize their fiscal policies and fiscal system with the *acquis communautaire*.

Value Added Tax (VAT), is the part of indirect taxes along with excise and customs and are considered financial instruments hereby taxation of a broad consumer and

services is achieved. According to the OECD statistics of 2014, in the structure of public revenues, VAT collects 30.5% of total revenues, while since 1965 the VAT participation in GDP in the OECD member states has increased from 3.2% to 7.0%. According to OECD statistics of 2016, 167 countries apply VAT. Perhaps the most significant driver for an indirect tax process overhaul, however, was the European Union's tax jurisdiction changes for e-commerce companies, effective January 1, 2015 (Gardner, 2016).

So VAT is value to be added to the taxable price of the product. In terms of researching appropriate methods for harmonization of various tax systems, important steps have been undertaken in order to achieve a full harmonization of tax systems in the field of VAT.

2.1. The Concept and Role of the VAT System in the EU

Historical development of the VAT system in the EU is directed on the role this financial instrument plays in the European integration process and establishment of a harmonization level towards the establishment and functioning of the *common market*. There is a legal framework dating back since EEC Treaty in 1957, where it was foreseen under Article 99 that the Commission should take actions to harmonize the legislation of member states in the field of indirect taxes, so... "*can be harmonized in the interest of the common market.*"

So, the accomplishment of the purpose of commercial exchange of goods, services, capital and free movement of persons can be realized only through finding a potential variation on the harmonization of the tax system (turnover taxes). These taxes are collected on the basis of principle "*country of destination*", which is a *contrary* principle of "*country of origin*". Based on these principles export is exempted from the tax obligation, in the case of being charged, it will be reimbursed, whereas, in order to prevent discrimination of foreign products, the import of products should be taxed the same as similar local products. In the context of harmonization of the VAT system, three factors are important such as:

- Standardization of the types of tax rates;
- Standardization of the list of goods and services that are subject to different tax rates;
- The level of tax rates.

Within the Member States, there are certain types of turnover tax systems:

- *Cumulative multi-stage system* - cascade that means at every stage of production tax from the gross value of output (production) is collected. This system has been used by countries like Germany, Luxemburg and Holland;
- *Non-cumulative/multi-stage system*, which means collecting the tax only on the net value of the product. This system has been used by France;
- *Mix system*, is primarily based on *cumulative multi-stage system*, which applies in most stages.

Tax obligation is performed in each stage of production and distribution. Depending on stages during the manufacturing and distribution process that product went through, we can understand how much tax was paid. This system has been used by states such as Belgium and Italy.

2.1.1. The Nature of the Provisions on Law Harmonization set by Primary Law

The study of ECC Commission, in 1962 for harmonizing turnover tax, with the nomination *The ECC Reports on Tax Harmonization* is considered as the first study in the field of harmonization. Therefore, the diversity of legislation and tax systems of EU member states initially was identified by the first working group on reports harmonization as follows:

- Difficulty of applying an average rate foreseen under Article 97 of the ECC;
- Encouraging the vertical concentration (integration) of the Companies inseparably in cascade system (multistage cumulative) of turnover tax;
- Barriers to the free circulation of goods caused from by the application of tax customs.

Complications that may arise in international commercial relations and that can be caused from the diversity of tax systems. Problems examined by *Neumark report*, about the extent of inequality of public finances within the EU Member States, prejudice the establishment of the *common market*, which should guarantee analogue conditions for all participants (De La Feria, 2009) and problems identified are based on the provisions of the ECC Treaty (2,3,7,17, 92, 95-102, 201, 220), e.g. Article 95, provided that: *the Member States shall not impose, directly or indirectly, on the products of other Member States any internal charges of any kind in excess of those applied directly or indirectly to like domestic products... or in a way as to afford protection to other products.* Whereas Article 97 of the Treaty of

ECC, provided that: *Any Member States which levy a turnover tax calculated by a cumulative multi-stage system may, in the case of internal charges imposed by them on imported products or of drawbacks granted by them on exported products, establish average rates for specific products or groups of products, provided that such States do not infringe the principles laid down in Articles 95 and 96.*

Neumark report, certainly qualifies as a prescient report on the issue of harmonization of VAT. (De La Feria, 2009)

Harmonizing tax, at this report was defined as abstaining obstacles in the mechanism of competition and as a gradual process which will pass through several stages and through which establishment of the common market will be achieved, which will enable the reduction of tariffs, free movement of capital, will create conditions to competition, aligning and unifying of production factors, standardization of prices, increased prosperity, increased resources for employment, etc.

3. Interpretation and Application of the VAT Directives

The European Union and its Member States participate in a complex legal system (Korenica & Doli, 2016). Within *secondary* sources of the EU, the following: Regulations, Directives and Decisions are considered as bylaws. The Directive is the most important legal instrument through which the dual objective of this instrument is achieved ensuring the necessary uniformity of EU legislation and respecting the diversity of traditions and national structure. Through this legal instrument, we manage to eliminate contradictions - conflicts between national legislation and various regulations, with the aim of creating equal material conditions for member states and serves as a key tool for the harmonization of national legislation with the *acquis*, in order to achieve *common market*. Based on the Recommendations of the Neumark Report, in 1962, the Commission has prepared a draft proposal of the *draft-directive*, concerning the harmonization of legislation on indirect taxes (VAT) between member states. It is proposed replacement of cumulative multi-stage system with the non-cumulative system, hereby eliminating the factors that distort competition.

Therefore, it is highlighted that the purpose of the common system of VAT should be ensuring neutrality, which will affect the competitiveness of each state, with the same benefits that will enable the application of VAT on the same rate, in the same

stages of production and distribution, simultaneously in international trade exchange will force the application of VAT fixed rate which will enable the establishment of clearer statements in terms of economic flows within the EU Community. In this context, it was foreseen that within four years to achieve harmonization of a common VAT system. However, the Commission's proposal, the European Parliament and the Committee on Economic and Social Affairs welcomes the purpose of establishing a common VAT system, but they have criticized the methods to achieve it. (De La Feria, 2009). During the discussion on the proposal in the European Parliament, member of the EEC Commission, Von Der Groeben presented his position with regards to tax harmonization issue and emphasized: "... to proceed further with the implementation of this proposal, we should have in mind two main objectives: we should eliminate distortion of competition and by the end of the transitional period we should abrogate all tax barriers." EP, following the discussion stressed the importance of removing barriers as soon as possible but rejected the Commission's proposal on the application of stages during the transitional period "considering as redundant".

Therefore, the Commission submitted the amended draft Directive in June 1964 regarding the harmonization of turnover taxes, presenting the amendments, as follows:

- In the first stage, those member states that impose circulation taxes from the *multi-stage cumulative* system will replace the *non-cumulative* system which is not necessarily needed to be the *value added* system;
- In the second stage, each "*non-cumulative*" system, presented at the first stage will be converted into common "*value added*" system;
- Determination of the period within which the transition of taxation systems should happen, namely approval and promulgation of laws in national parliaments (of Member States) prior 31 December 1967, whereas entry into force may postpone until December 1969;
- The ultimate goal of harmonization of turnover taxes is eliminating of fiscal – tax barriers.
- The main characteristics of *common added – value tax*:
 - by nature will be a *general tax on consumption*;
 - it will be collected on the basis of *partial payment system*;

- Value added will be determined by tax on tax deduction.

Therefore, the Commission decided to reconsider the proposal. However, in 1965, the Commission presented the proposal for the Second Directive.

While, in 1967, the Council with some modifications admitted:

- First Directive on the harmonization of legislation in member states on turnover taxes; and
- Second Directive on the harmonization of legislation in member states on turnover taxes - Structure and procedures of applying the common VAT system.

These two directives enable the initiation of the VAT application as a new form of tax by replacing output tax and consumption tax, which was used in the EU member states.

3.1. Sixth Directive

The European Commission, due to the appearance of delays in the implementation of the First and Second Directive from EU member states, by mid-1973, so that in this year the EC submitted a proposal for the sixth directive on the harmonization of legislation of member states concerning turnover taxes and establishing uniform tax basis. A year later it amended the abovementioned proposal.

Then, following the report of the Committee on Budget, the EC submitted to the Council the proposal for the *Sixth Directive* and same was approved in May 1977.

In the preamble of *Sixth Directive*, it is stated that:

- A necessary requirement of EU member states to ensure a common system of VAT based on the principle of non-discrimination of the country of origin of the progress and service, in this way the common market to function as a mechanism where free and fair competition shall ensure the functioning of common market;
- The subject of conflict between the jurisdictions of different member states is the meaning of expressions: *taxable person* and *taxable transaction*;
- Particularly, in terms of the place of supply with goods and the place of supply with services and its modalities;
- Within the UE Community it should be done the harmonization of obligation and tax burden and harmonization of tax rates;

- Requirement of harmonization of the rules which will be applied upon the application of tax deductions and establishing a uniformed way of its application at all member states;
- Determination of entities which will become taxpayers and in particular when the service supplier is non-resident;
- Application of special schemes, e.g. for farmers and application of flat rates.

Sixth directive, marks a step towards achieving the goals for which EEC has been established, which were: elimination of fiscal barriers, creating the conditions to fair competition and neutrality in international trade, full financial integration, and creating own sources of financing. So, there are two systems of flat rates applicable in the Community:

1. Compensation of tax paid from the purchase *via* sales price by the farmer. This system operates in such a way that the farmer increases the product price by applying the flat rates, i.e. in the *gross* price it is added the VAT; and
2. Compensation of already paid tax in the purchase via reimbursement from tax authorities. According to this system, *a farmer* sells the products with *net* price and does not add the VAT.

Therefore, it is reimbursed at the amount of applying the flat tax rate in the sold product.

However, despite the changes, the above - mentioned innovations and achieved progress, it appeared the need of its amendment; therefore, the European Commission submitted some requirements with proposals for regulating some issues remaining unregulated by the sixth directive. The proposed amendments to the Council's Regulation concerning the extension of validity of the implementation of the Regulation with regard to the own sources deriving from VAT. The basic principles, on which the VAT system has been established, regulated by provisions of *Sixth Directive*, do not have any major substantial changes from the way of adjustment with the *Second Directive*. In terms of defining the taxable individuals and taxable transactions in the second and sixth directive the definitions are almost similar. According to the *sixth directive*, Article 30 the member states which achieve an agreement with third countries or any international organization may require with a special request the derogation of a part of this directive, therefore, in 1982 the Italian government informed the Commission about the requirement for derogation from *the sixth directive* in the

context of draft Convention for maintenance of borders between Italy and Austria signed in 1929.

The goal of the requirement for Convention's derogation was the creation of possibility of exemption from VAT payment, final imports of materials that will be used, motor vehicles, equipment and other work tools for maintenance of border. The same procedure was followed by the Dutch Government with regard to secret activities of sub-contractors (from Germany) and responsible persons for safety at work, in buildings, iron structures (scaffold), shipping industry constructors and health insurance payment – premium, tax on salaries and VAT. In 1983, German and Luxemburg governments informed the Commission about their requirement with regard to the derogation of Article 27 of *the sixth directive*, due to the agreement reached between Germany and Luxemburg concerning the simplification of VAT collection on transactions dealing with construction and maintenance of border bridges, whereas, the requirement for derogation of some articles of *the sixth directive* was approved enabling the application of *the seventh directive*. The EC, in this way, amended the proposal for *the seventh directive* (Articles: 2.3; 2.5; 2.6; 3.2; 3.5 ; 3.6 ; 4.1; 4.2) dealing with the taxable amount for the work of arts, goods collectors, antiquities that will be 30% of sales price or the difference between sales price and purchase price, cases when the VAT deduction will not be applicable, scheme of used stuff and the amendment of Article 3.6 where it is foreseen the case when the taxable person may require deduction of paid VAT in the case of acquisition of goods.

All these amendments are in compliance with Article 149, paragraph 2 of the EEC Treaty. The EC, through the proposal for *the eighth directive* drafted by Mr. Bruke, aiming the presentation of a joint agreement for VAT reimbursement within the Community, because in this way it will also be regulated the VAT reimbursement aspect foreseen in *the sixth directive*. In article 17, item 3 and 4 of *the sixth directive* provided that as far as the Council adopts a reimbursement agreement, each member state is free to determine the way of reimbursement. Through this directive, an equal treatment of economic operators in international trade is enabled in terms of the VAT and in this way economic integration in the Common European Market will be available enabling free movement of persons, goods, services and capital. With the aim of establishing technical conditions of application of the VAT system efficiently, a proposal concerning mutual assistance of relevant authorities of member states in the field of VAT was adopted. Three main reasons that push the relevant authorities to provide assistance are as follows:

- First, information from member states about data hiding on international trade and the use of false invoices of export;
- Secondly, to ensure that VAT is charged on each occasion that the sixth directive provides, then cooperation of national departments of public revenues, would facilitate this control and will avoid non-taxation or double taxation;
- Thirdly, close cooperation between national authorities will specify the tax duties on income and profits.

Based on *the Sixth Directive*, Article 9.1 a place where the supplier has established his business will be treated as the place of supply with services. In the tenth directive, Article 1 defines the place of service as: “*in cases when movable assets are leased, in addition to transport means, the supplier is considered to establish business area in the place where the good (property) currently is available, and it makes possible to the customer*”. While with the sixth directive, section 3, point 1, 2, 3 defines the meaning of the territory of the Member States and compulsory counts territories which are considered “exempted” from the territory of member states, where are also included the Republic of France with its foreign territories. Therefore, they are excluded from the scope of the VAT system amending the sixth directive through the proposal for the eleventh directive for harmonizing the laws of the Member States relating to turnover taxes and exemption of foreign territories of France from the scope of Directive 77/388/ECC. Pursuant to Article 17, paragraph 6 of *the Sixth Directive* for harmonizing the laws of the Member States relating to turnover taxes and the common VAT system, in terms of regulating specifically the expenses on which deduction of VAT cannot be applied to the costs that are not directly related to the business activities such as the Consumer expenses on food, beverages, accommodation, transport costs, cost of vehicles not dedicated for business, luxury stuff, entertainment or fun. According to *the sixth directive*, Article 17, paragraph 4, member states are free to determine the reimbursement method of non-resident taxable persons ; the Member States may refuse the reimbursement or impose new conditions until is not regulated by a new special directive. A trader who is resident in a non-member state faces with difficulties regarding the accomplishment of the right to reimbursement of the VAT invoice payment. This issue is partially regulated by the eighth directive as well, therefore the EC proposed *the thirteenth directive* in order to harmonize the rules within member states of the community in order to act similarly in

reimbursement cases towards the Community and third countries, in terms of promoting and ensuring competition and European economic integration process.

4. Conclusion

Throughout the history of the European Union, tax harmonization policies have been developed in terms of achieving full integration of the different tax systems in a common market. Through *harmonization of tax systems* of countries which aspire to full membership into the EU, the establishment of a common market will be achieved aiming at free movement of persons, goods, services and capital. This paper concludes that the results of tax harmonization were significantly achieved to indirect taxes, while in direct taxes there are still significant gaps and resistance from member states and the countries aspiring to make full harmonization because an exclusive competence of a state is to determine the structure of a tax system within its jurisdiction whereby extends its sovereignty, so through direct tax forms will determine the attractiveness of their economy and ensure competitiveness in the foreign investment market. Neutral tax system, generated through the tax harmonization within the European Union, would give the advantage of eliminating distortions in economic decisions. With the reformation and harmonization of tax systems and its structure with the *acquis*, it will enable aspiring countries to have an efficient economy, lower tax evasion, the shadow economy level, also help to increase collection of budget revenues and funding of public needs. The article therefore concludes that VAT is easily acceptable tax by taxpayers paid within the final price. Therefore, often referred to VAT as tax payable under *anesthetic*. Therefore, a collection of this financial instrument by the state, considered easier than other tax forms. So, the article concludes that the resistance for payment of VAT is very low.

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