EUCOTAX Series on European Taxation

VAT/GST in a Global Digital Economy

Edited by

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Wolters Kluwer
Law & Business

Published by:
Kluwer Law International
PO Box 316
2400 AH Alphen aan den Rijn
The Netherlands
Website: www.wklawbusiness.com

Sold and distributed in North, Central and South America by:
Aspen Publishers, Inc.
7201 McKinney Circle
Frederick, MD 21704
United States of America
Email: customer.service@aspenpublishers.com

Sold and distributed in all other countries by:
Turpin Distribution Services Ltd
Stratton Business Park
Pegasus Drive, Biggleswade
Bedfordshire SG18 8TQ
United Kingdom
Email: kluwerlaw@turpin-distribution.com

Printed on acid-free paper.

ISBN 978-90-411-5952-6

Printed and Bound by CPI Group (UK) Ltd, Croydon, CR0 4YY.

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CHAPTER 2A

The Treatment of 'Digital Products' and Other 'E-Services' under VAT

Marie Lamensch

§2A.01 INTRODUCTION

Internet technology makes it possible to deliver digital products and e-services[1] to taxable and non-taxable e-customers located all over the world. In the field of VAT, the development of digital products and e-services raises several basic questions, including questions as to how these supplies should be characterized or defined for VAT purposes (section §2a.02), where they should be taxed and how tax assessment can be effected in a digital context (section §2a.03) and whether they should be eligible for the application of reduced rates, which are traditionally reserved for conventional supplies[2] (section §2a.04). This chapter will summarize the issues at stake under each of these basic questions and make tentative suggestions for the way forward.

§2A.02 CHARACTERIZING AND DEFINING DIGITAL PRODUCTS AND E-SERVICES

Because of their intangible nature, e-services and digital products are currently characterized for VAT purposes either as *services*[3] or as *services and intangibles*,[4] as

1. Among supplies delivered/performed via the Internet (e-supplies), a distinction can be made between digital products (e.g., e-books, online journals and downloadable music) and e-services (e.g., webinars, distance teaching and fitness coaching applications).
2. As opposed to e-supplies.
3. For example in the European Union, Norway, New Zealand, Singapore or South Africa.
4. For example in Canada, or in the OECD recommendations on e-commerce and the more recent OECD International VAT/GST Guidelines. The OECD recommendations on e-commerce consist of the 1998 Ottawa Framework (OECD, Committee on Fiscal Affairs, *Electronic Commerce: Taxation*

opposed to goods or real property.[5] The way digital products and e-services are characterized for VAT purposes may be seen as little more than a technical issue. However, first, characterizing all digital products and e-services as services is a conservative approach to the digital economy, which does not make an easy fit for digital products (such as e-books, online journals or downloadable music). Second, distinguishing between digital products (intangibles) and e-services (services) is actually not sufficient if e-services are not further defined or identified in one way or another within the broad category of services for the purpose of applying specific rules to them, if and where needed (e.g., as regards tax assessment and collection). The same applies to systems that do not differentiate between digital products and e-services and characterize them all as services; beyond the question of the artificiality of the characterization of digital products as services, both digital products and e-services should be clearly identified within that broad category, again in order to be able to apply specific rules. The rather technical question as to the characterization of digital products and e-services therefore has an impact on their substantive VAT treatment.

The EU legislature was the first to set-up a specific sub-category for 'electronically supplied services' in EU VAT legislation[6] (digital products and e-services being all

Framework Conditions, presented to Ministers at the OECD Ministerial Conference, A Borderless World: Realising the Potential of Electronic Commerce, 8 October 1998) and its subsequent implementing guidelines, which include a 2001 report by OECD Working Party No. 9 (OECD, Committee on Fiscal Affairs, Working Party No. 9, *Consumption Tax Aspects of Electronic Commerce* (February 2001), available at http://www.oecd.org/ctp/consumption/2673667.pdf), based on two 2000 reports from the OECD Consumption Tax and Technology technical advisory groups (TAGs) (OECD, *Report by the Consumption Tax Technical Advisory Group (TAG)* (December 2000); OECD, *Report by the Technology Technical Advisory Group* (TAG) (December 2000), available at http://www.oecd.org/tax/consumption/1923248.pdf), a 2003 report by OECD Working Party 9 (OECD, Implementation of the Ottawa Taxation Framework Conditions, The 2003 report, http://www.biac.org/members/tax/BEPS/2003_OECD_Report_on_Ottawa_Framework_Conditions20499630.pdf), and a 2003 Consumption Tax Guidance Series (the reports composing this series can be downloaded at: http://www.oecd.org/fr/ctp/consommation/consumptiontaxguidanceseries.htm). Since 2006, the OECD has been working on the more ambitious 'International VAT/GST Guidelines' for the application of consumption taxes to cross-border transactions in goods, services and intangibles (OECD, *International VAT/GST Guidelines*, available at http://www.oecd.org/ctp/consumption/international-vat-gst-guidelines.pdf. At the moment, only guidelines for B2B supplies of services and intangibles have been adopted by the OECD Council (in April 2014). Draft guidelines for B2B supplies of services and intangibles are currently under discussion. Discussion on guidelines for supplies of goods have not yet started. The guidelines that have been adopted (and discussed) so far build on the Ottawa Framework principles and their implementing guidelines. Notably, therefore, 'in contrast to what has occurred for income taxes, instead of working from a broader set of agreed paradigms towards a specific e-commerce application, the "internationally" agreed paradigms for the cross-border application of consumption taxes are being grown from the seeds planted by the work on e-commerce'. A. Cockfield et al., *Taxing Global Digital Commerce* (Kluwer 2013), at 200.

5. In Australia, they fall under the broad category of 'anything other than goods or real property'.
6. Currently based on Council Directive 2006/112 of 28 November 2006 on the Common System of Value Added Tax, OJ L347/1 (11 December 2006). The specific provisions on electronically supplied services were introduced by Council Directive 2002/38 of 7 May 2002 amending and amending temporarily Directive 77/388/EEC as regards the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services. Council Directive 77/388/EEC was eventually recast in Council Directive 2006/112.

primarily characterized as services under the EU VAT system), which are defined as: 'services which are delivered over the Internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, and impossible to ensure in the absence of information technology'.[7] The positive aspect of this definition is that specific place of supply, assessment, collection, rate and tax liability rules may subsequently be applied to these electronically supplied services, with the objective to tackle their specifics – which is not possible in the many systems that do not differentiate between supplies/services made conventionally and electronically.

This having been said, the requirement that electronically supplied services be 'essentially automated' and involve 'minimal human intervention' unfortunately means that this definition mainly covers digital products such as downloadable music and videos, but does not cover several e-services such as the supply of webinars, distance teaching[8] or remote computer repair services,[9] even if these supplies are also being entirely delivered/performed via the Internet. This definition is therefore unfortunately too narrow to cover all digital products and e-services, with the consequence that some of them technically cannot be subject to specific rules. It is actually narrower than the scope of application of the OECD recommendations on e-commerce,[10] which the EU legislature sought to implement when it adopted specific provisions for electronically supplied services in its VAT legislation,[11] and which apply more broadly to any 'cross-border supplies of services and intangible property capable of delivery from a remote location'.[12]

Against this background, it is here suggested, first, that digital products and e-services should be more simply characterized, together with conventional services, as intangibles for VAT purposes, as opposed to goods or real property and, second, that

7. Article 7 *Council Implementing Regulation (EU) 282/2011 of 15 March 2011 Laying Down Implementing Measures for Directive 2006/112/EC on the Common System of Value Added Tax*, OJ L77/1 (23 March 2011).
8. That is remote participation in classes (only e-learning modules are covered).
9. See clarification examples in Article 7 and Annex I of Council Directive 282/2011 of 15 March 2011 laying down implementing measures for Directive 2006/112/EC on the common system of value added tax.
10. *Supra* n. 4.
11. When the EU adopted Council Directive 2002/38, it claimed to have become '[…] the first significant tax jurisdiction in the world to develop and implement a simplified framework for consumption taxes on e-services in accordance with the principles agreed within the framework of the Organisation for Economic Co-operation and Development (OECD). The Directive therefore complements the international process at the OECD' (see European Commission webpage on e-commerce and VAT, http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/telecom/index_en.htm). In the same sense, see European Commission, *Report from the Commission to the Council on Council Directive 2002/38/EC of 7 May 2002 Amending and Amending Temporarily Directive 77/388/EEC as Regards the Value-added-tax Arrangements Applicable to Radio and Television Broadcasting Services and Certain Electronically Supplied Services*, COM(2006) 210 final, 2006/0069 (CNS).
12. See e.g., OECD Working Party No. 9, *Consumption Tax Aspects of Electronic Commerce* (February 2001), *supra* n. 4, at 10.

specific rules should apply (where needed) to all supplies of intangibles made 'on a fully remote basis via the Internet or any other electronic network'.[13] The primary characterization as intangibles would be less artificial for digital products and would focus on the specifics that digital products, e-services and conventional services all share, namely their intangibility, and would also suppress the unnecessary distinction (at least for VAT purposes) that is sometimes made between intangibles and services.[14] The application of specific rules to all supplies of intangibles that are made on an entirely remote basis via the Internet or any other electronic network, would then be broad enough to cover all supplies that effectively need to be subject to specific rules because of the specific context in which they are taking place (e.g., as regards tax assessment, as will be discussed in the next section), without the need to further define them.[15]

§2A.03 PLACE OF TAXATION AND ASSESSMENT RULES FOR DIGITAL PRODUCTS AND E-SERVICES

VAT on cross-border transactions is traditionally levied at destination,[16] and even if this jurisdiction rule is difficult to implement in a digital context (as will be discussed, below), it should be the case without exception in the sector of digital products and other e-services (hereinafter, e-supplies). This, because an origin-based taxation typically distorts consumption decisions in favour of suppliers located in jurisdictions applying a low rate of VAT and because it thus also creates an incentive for businesses to establish themselves in such jurisdictions.[17] These distortions take a particular dimension in the sector of e-supplies in which the location of the e-supplier does not matter whatsoever from an e-customer's perspective.

The traditional proxies for implementing the destination principle to supplies of services and intangibles include the customer's principal place of business for supplies

13. A detailed proposal along these lines is made in M. Lamensch, *European Value-Added-Tax in the Digital Era: A Critical Analysis and Proposals for Reform* (2014)(doctoral thesis, to be published by the IBFD).
14. The relevant distinction to make for VAT purposes is between conventional and e-supplies.
15. It being understood that even more specific rules could apply, where needed, to supplies such as telecommunication and broadcasting services. See *supra* n. 13.
16. A. Schenk & O. Oldman, *Value-added-tax, a Comparative Approach* (Cambridge University Press 2007), at 35 ('Virtually all VATs use the so-called destination principle under which personal consumption is taxed in the country of destination, which is assumed to be the country of consumption'.). See also OECD, International VAT/GST Guidelines, at 24.
17. OECD, *International VAT/GST Guidelines on Neutrality*, approved by the Committee on Fiscal Affairs on 28 June 2011, available at http://www.oecd.org/ctp/consumption/guidelinesneutrality2011.pdf, at 5. See also J. Mirrlees (2011): *Tax by Design*, The Mirrlees Review (Oxford University Press), at 184; R. Van Brederode (2009): *Sales Taxation*, (Kluwer), at 205; T.M. Le, *Value-added-taxation: Mechanism, Design, and Policy Issues*, Paper prepared for the World Bank course on Practical Issues of Tax Policy in Developing Countries (Washington D.C., 28 April–1 May 2003), at 21; J.E.S. Oliveira (2001): *Economic Effects of Origin and Destination principle for Value-Added Taxes*, School of Business and Public Management, George Washington University.

to taxable persons (or B2B supplies)[18] and the customer's place of residence for supplies to non-taxable persons (or B2C supplies).[19] Alternative proxies may apply as an exception to the general rule, with the objective of increasing the chance that taxation takes place where consumption occurs.[20] For example when a taxable person carries out its business through entities located in several jurisdictions (multiple-location customer), the tax may be due in the jurisdiction where the entity that will effectively use the supply is located.[21] In the case of supplies to non-taxable persons, traditional alternative proxies include the jurisdiction in which the customer spends the majority of his or her time (e.g., a second residence) or the place where the supply is effectively used and enjoyed.[22]

When the destination principle applies, suppliers are traditionally required to ascertain the status and location of their customers in order to charge the correct amount of VAT. In fact, for supplies made to non-taxable persons, suppliers must assess the VAT due on each of their supplies in accordance with the rules that apply in the jurisdiction of consumption (which jurisdiction they should therefore be able to locate, even if, ultimately, no VAT is actually due under the rules that apply in that jurisdiction). For supplies to taxable customers, even if they can be required to pay the VAT due on their cross-border purchases to their home tax administration on a self-assessment basis (reverse charge system),[23] suppliers still need to ascertain their customer's taxable status and location before proceeding to a tax-free export, in order to ensure that the self-assessment procedure is indeed applicable. In the case of e-supplies, the parties do not meet, and they take place at any time of the day or year. As a consequence, identifying and locating taxable and non-taxable e-customers unfortunately proves a difficult task, due to the difficulty for e-suppliers to obtain reliable information on their e-customers in the very short time frame in which the transaction is completed and in which tax assessment must thus be performed. A complicating factor is the potentially unlimited number of jurisdictions in which an e-customer can be located. The concepts of distance and geographic location have indeed simply blurred in the case of e-supplies, and cross-border supplies to

18. Which proxy was defined as *the main rule* for implementing the destination principle in the OECD International VAT/GST Guidelines dedicated to B2B supplies of services and intangibles, at 25.
19. The OECD International VAT/GST Guidelines regarding supplies of services and intangibles to non-taxable persons have not yet been adopted and are currently in draft form (available at: http://www.oecd.org/ctp/consumption/discussion-draft-oecd-international-vat-gst-guidelines .pdf). Taxation by reference to the place of residence of the customer is the rule which, for example, applies, in principle, in the EU.
20. This is, for example, what is recommended in the OECD International VAT/GST Guidelines regarding supplies to multiple-location customers (at 27) and what is provided for in the EU VAT system for supplies of services to both taxable and non-taxable persons.
21. This is what is recommended under the OECD International VAT/GST Guidelines for B2B supplies of services and intangibles, at 27.
22. For example under the EU VAT system. Article 24(2) Council Regulation 282/2011 implementing Council Directive 2006/112 and 59a of Council Directive 2006/112).
23. As recommended in the OECD International VAT/GST Guidelines dedicated to supplies of services and intangibles to taxable persons, at 31.

e-customers have become as easy and common to conduct as domestic transactions while taking place in anonymity.

To solve that problem, the OECD recommendations on e-commerce suggested, 'for the short term', that e-customers identify themselves (i.e., communicate status and location information to their e-suppliers), and that e-suppliers verify this information on a transaction basis.[24] This is also the approach that prevails for supplies of conventional services to taxable persons under the OECD International VAT/GST Guidelines for B2B supplies of services and intangibles (2014). In these more recent guidelines (which are meant to tackle supplies of conventional services, e-services and intangibles altogether),[25] it is recommended that e-suppliers verify the identity and location of single-location e-customers on the basis of information available in the business agreement concluded by the parties.[26] However, there is, unfortunately, no guidance on what to do in the absence of an existing business relationship and detailed business agreement, which is typical for e-supplies that have a more occasional character than do conventional supplies, and that commonly take place in the absence of an established business relationship between the parties.[27]

For supplies to multiple-location customers, the OECD International VAT/GST Guidelines for B2B supplies of services and intangibles (2014) suggest that three approaches are possible:[28] (i) the direct use approach (which allocates taxing rights to the jurisdiction of the customer's establishment that is regarded as using the service or intangible), (ii) the direct delivery approach (which allocates taxing rights to the jurisdiction of the customer's establishment to which the supply is delivered) and (iii) the recharge method (which allocates taxing rights to the jurisdiction in which the customer is established according to the business agreement, and which requires that the multiple-location customer subsequently recharge the cost of an externally acquired service or intangible to the establishment that uses it, which would be achieved by treating these internal recharges as internal supplies that are within the scope of VAT).[29]

24. OECD, Working Party No. 9, *supra* n. 4, at 7.
25. *Supra* n. 4.
26. OECD, OECD, *International VAT/GST Guidelines*, see *supra* n. 4, at 25.
27. And the clarification in the guidelines that the concept of business agreement on which tax assessment should be based 'include, for example, general correspondence, purchase orders, invoices, payment instruments and receipts' is not really helpful and actually seems relevant mainly in the context of supplies of traditional services when there is more time for (manual) verifications and these elements could indeed taken into consideration. For a more detailed commentary on these guidelines initially published as drafts in 2010, see M. Lamensch, *OECD Draft Guidelines on VAT/GST on Cross-Border Services*, 21 International VAT Monitor 4 (2010), at 271.
28. OECD, *International VAT/GST Guidelines*, *supra* n. 4, at 27.
29. OECD, *International VAT/GST Guidelines*, *supra* n. 4, at 34–35. Guideline 3.5 reads as follows: 'For the application of Guideline 3.4, the OECD has adopted the following Guideline: In those cases where the services are used by one or more establishments other than the establishment that entered into the business agreement, the taxing rights are allocated in two steps. In the first step, taxing rights are allocated to the jurisdiction where the customer establishment that enters into the business agreement is located. In the second step, taxing rights are allocated to the jurisdiction where the customer establishment that uses the service or intangible under a recharge arrangement is located'.

Of these methods, the last two seem to be the least inappropriate for e-supplies, as they relieve e-suppliers from the obligation to determine whether a business customer is a multiple-location entity, and which of the different entities will effectively use the supply. But as noted above, the question remains open as to what to do in the absence of an existing business relationship and detailed business agreement. Accordingly, the guidelines do not seem entirely workable for e-supplies, neither for single-location customers nor for multiple-location customers (i.e., at least not workable in cases where there is no established business relationship between the parties).[30] In fact, it is suggested here that even though the OECD International VAT/GST guidelines concerning B2B supplies of services and intangibles (2014) are sound for what concerns supplies of conventional services, they do not seem entirely workable in the specific context of e-supplies.[31] More precisely, it is suggested that, while the OECD ambition to broaden the scope of its work on VAT to all types of international supplies is sound and desirable, because further coordination in the field of VAT is essential in an increasingly globalized economy, a common treatment of services and intangibles in that context may run the risk of overlooking e-supply specifics and, as a consequence, failing to provide the right answers to the specific questions that they raise.

In its early recommendations on e-commerce,[32] the OECD had suggested that VAT registration numbers be used to verify the status of e-customers.[33] Verifying an e-customer's taxable status and place of business can indeed be a rather straightforward process if official tax registration numbers can be checked on a real-time basis by

30. Guideline 3.6 reads as follows: 'The taxing rights over internationally traded services or intangibles supplied between businesses may be allocated by reference to a proxy other than customer location as laid down in Guideline 3.2, when both the following conditions are met: a. The allocation of taxing rights by reference to customer location does not lead to an appropriate result when considered under the following criteria: Neutrality, Efficiency of compliance and administration, Certainty and simplicity, Effectiveness, Fairness. b. A proxy other than customer location would lead to a significantly better result when considered under the same criteria'. Guideline 3.7 reads as follows: 'For internationally traded business-to-business supplies of services and intangibles directly connected with immovable property, the taxing rights may be allocated to the jurisdiction where the immovable property is located'. The OECD International VAT/GST guidelines for B2B supplies of services and intangibles also propose specific rules that may apply when the main rule (customer place of business) does not lead to an appropriate result in light of the principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and if another proxy could lead to a significantly better result. The examples given by the Report, however, do not concern e-supplies (but rather supplies related to immovable property and restaurant services).
31. In the previous section it was suggested that digital products, e-services and conventional services all be primarily characterized as intangibles for VAT purposes, but that specific rules should apply to e-supplies (digital products and e-services) because, although sharing an intangible nature with conventional services, they are taking place in a specific context that commands the application of specific rules.
32. *Supra* n. 4.
33. OECD, Working Party No. 9, *supra* n. 4, at 18; OECD, Centre for Tax Policy & Administration, Consumption Tax Guidance Series, *Paper No. 3, Electronic Commerce: Verification of Customer Status and Jurisdiction* (2003), available at http://www.oecd.org/tax/consumption/5574687.pdf, at 3. For background, see OECD, Centre for Tax Policy & Administration, Consumption Tax Guidance Series (2003), *Paper No. 1, Electronic Commerce: Commentary on the Place of Consumption for Business to Business Supplies (Business Presence)*, available at http://www.oecd.org/tax/consumption/5592717.pdf; *Paper No. 2, Electronic Commerce: Simplified Registration Guidance*, available at http://www.oecd.org/tax/consumption/5590980.pdf.

e-suppliers. However, there is, unfortunately, no worldwide VAT registration number database, and expecting e-suppliers to consider local tax certificates or any other document evidencing the taxable status of an e-customer, on a transaction basis, in any language, and in the very short time frame in which an e-supply takes place, seems an impossible requirement.

The only example of regional coordination is the EU VAT Information Exchange System (VIES or VIES database) in which the VAT numbers of all EU taxable persons supplying cross-border within the EU are, in principle, available. However, one problem is that EU taxable persons not selling intra-EU, but willing to purchase from a supplier located in another EU Member State, will not be able to demonstrate their taxable status through the VIES database. This is not a minor issue if the VIES were to be relied on in the EU as the only reliable tool to verify the status of taxable e-customers, in view of the fact that the OECD recently reported that businesses rely more on the Internet for purchasing than for selling (in 2010, on average, 35% of all businesses with ten or more persons employed used the Internet for purchasing, and only 18% for selling goods and services).[34] Another problem is that if the VIES allows suppliers to confirm that a VAT number effectively exists and is related to a certain taxable person, it remains difficult for an e-supplier to ascertain that a VAT number used by an e-customer effectively belongs to that e-customer.

Verifying the place of business of a taxable person on a real-time basis may also prove difficult. It is actually impossible in the absence of a VAT registration number database, and even with the VIES database is not always possible because addresses are not systematically shown in connection with the taxable person's VAT number. Moreover, if e-suppliers need to consider the location of the business entity that will effectively use the supply in the case of a multiple-location customer (as is the case in the EU), a VAT number database is insufficient.

Finally, there is no official database available to e-suppliers that would allow them to determine where their non-taxable e-customers reside. As indicated above, OECD VAT/GST Guidelines have not yet been released concerning B2C supplies of services and intangibles, but are a work in progress. The suggestion by OECD Working Party No. 9 in its early recommendation on e-commerce was (again 'for the short term') that e-suppliers rely on 'other indicators' in order to charge the correct amount of VAT on their supplies.[35] Indicators that immediately come to mind include the IP address and payment details. However, the Working Party excluded them in its 2001 report 'even as interim (and "less than perfect") arrangements', based on the conclusions of its Technology Technical Advisory Group (TAG).[36]

One reason is that 'further investigation demonstrated that there was no numerical BIN correlation to geography, no uniformity across credit card clearing systems, and significant privacy and business model reasons why the information could not be

34. OECD, *Internet Economy: Outlook 2012 Highlights* (OECD Publishing 2012), available at http://www.oecd.org/sti/ieconomy/internet-economy-outlook-2012-highlights.pdf, at 4.
35. OECD, Working Party No. 9, *supra* n. 4, at 18; OECD, Centre for Tax Policy & Administration, *Paper No. 3*, *supra* n. 33, at 13.
36. OECD, Working Party No. 9, *supra* n. 4, at 14.

shared'.[37] Another reason was that using IP addresses as a proxy for jurisdictional verification has limits in terms of its reliability and capacity to be manipulated, and moreover runs the risk that the IP address does not correspond to a declaration of residence by a travelling customer (bearing in mind that the IP address of an e-customer is indeed not the proxy that is recommended as a general rule for implementing the destination principle, but only one of the possible indicators that suppliers could take into consideration for implementing the proxy of the place of residence).[38]

However, in the OECD Consumption Tax Guidance Series (2003), IP addresses are considered as possible indicators for verifying customer location, although it is stressed that:

> [c]larification or agreement between the relevant revenue authority and the business sector as to what rules should be applied in the scenario where an instance of a customer's self declaration of jurisdiction does not match the jurisdiction indicated by a verification technology or system is desirable.[39]

Other indicators, like a billing address, seem even less reliable because the e-customer does not need the supplier to know where he or she resides, and giving a wrong billing address with the objective to obtain a lower VAT rate will have no consequence for the e-customer. In fact, as acknowledged by OECD Working Party No. 9, requiring that e-suppliers verify, on a transaction basis, the status and location of their e-customers is not optimal, and this approach should be kept under review. In

37. OECD, *Report by the Technology Technical Advisory Group* (TAG) (December 2000), at 28, available at http://www.oecd.org/tax/consumption/1923248.pdf. It is noteworthy that since the publication of this report, payment intermediaries (such as PayPal) and e-cash have also developed, allowing e-customers to not disclose their credit card number to their e-suppliers.
38. The Technology TAG report notes that although IP addresses offer potential in that they are an essential part of every access point to the Internet, they have limitations, such as single worldwide access points for AOL users and corporate aggregators, use of anonymizers and potential for spoofing, such that the costs of implementation may not be worthwhile. In addition, there was significant reluctance on the part of business representatives in the TAG as regards such systems because of concerns regarding the lack of commercial necessity and limited utility, as well as the potential development of new IP addresses systems which would require different IP tracking systems, costs of implementation and potential for disruption of service in cases of unclear results. The Technology TAG also highlighted increasing consumer sensitivity about personal privacy and data protection, and businesses were, in general, reluctant to seek to collect more information from customers than they needed for commercial purposes (OECD, Working Party No. 9, *supra* n. 4, at 13). Also in that sense, see D.J.B. Svantesson (2007): *E-Commerce Tax: How the Taxman Brought Geography to the Borderless Internet*, 17 Revenue Law Journal 1 (2007). There are two further reasons why it seems difficult to require that e-suppliers use e-customers' IP addresses in the context of their VAT compliance obligations. First, it seems excessive to require that all e-suppliers invest in IP trackers, in particular if tax administrations would not accept any IP tracker but would be tempted to impose the use of *certified* devices to ensure a maximum level of reliability. Second, locating customers' IP addresses and storing this information for several years may breach data protection legislation in a number of jurisdictions (including the EU).
39. OECD, Consumption Tax Guidance Series, *Paper No. 3* (2003), *supra* n. 33, at 8. As noted above, the proxy for implementing the destination principle usually remains the place of residence/business of the customer, and in that context identifying an IP address is only one way to determine where this place is located, without the actual location of the e-customer becoming the applicable proxy.

fact, the recommendation made by that Working Party was, for the long-term, to investigate technology-based solutions to tackle the question of e-customer identification and location.[40]

It may indeed seem clear that requiring suppliers to verify information provided by their customers on a transaction basis may work fairly well in conventional supplies (of services), in which the parties will usually meet and in which there is more time for proceeding to verifications, but is not appropriate in a digital context in the absence of workable tools enabling e-suppliers to obtain reliable information in a timely fashion. The latter case imposes an insurmountable and unrealistic compliance burden on e-suppliers without ensuring legal certainty because, in some cases, the compliance obligations cannot be complied with. Moreover, it would be difficult for tax administrations to assess, a posteriori, the relevance of the criteria retained by e-suppliers in each of their assessments, and if audits cannot easily be performed, this would inevitably result in a loss of tax revenue for states.[41]

Accordingly, it is suggested here that any attempt to build on this basic approach is bound to fail, whether by providing more detailed rules regarding the type of information and different possible sources that could be relied on by e-suppliers to verify e-customers' allegations concerning their status and location, or by using legal artifices such as under the forthcoming EU presumptions for customer location. The EU presumptions for customer location, upon closer look, prove even more difficult and burdensome to implement, because they are based on the assumption, on the one hand, that e-suppliers have the possibility to proceed to transaction-based assessments and arbitrages, and that they have access to very specific information regarding their e-customers or regarding the type of Internet connection that they use on a transaction basis and, on the other hand, that tax administrations are able to verify that e-suppliers have correctly implemented the presumptions.[42]

Against this background, for the purpose of implementing a destination-based taxation of e-supplies, it would seem advisable, as put forward by OECD Working Party No. 9 in its early recommendations on e-commerce, that states consider developing technology-based automated systems for tax assessment (and collection).[43]

A preliminary question concerns the applicable proxies. As discussed above, while the jurisdiction of residence/business of the customer is traditionally relied on, alternative proxies may be used to ensure that taxation occurs – to the extent possible

40. OECD, Working Party No. 9, *supra* n. 4, at 8; OECD, Consumption Tax Guidance Series, *Paper No. 3* (2003), *supra* n. 33, at 10.
41. For more on this, and with a focus on the EU VAT system, see M. Lamensch, *Unsuitable Place of Supply Rules for Electronic Services in the EU: Proposal for an Alternative Approach*, 4 World Tax Journal 1 (February 2012), at 77; M. Lamensch, *Are 'Reverse Charging' and the 'One-Stop-Scheme' Efficient Ways to Collect VAT on Digital Supplies?* 1 World Journal of VAT/GST Laws 1 (2012), at 1.
42. A detailed analysis of the soon to be applicable presumptions is made in Lamensch, *European Value-Added-Tax in the Digital Era: A Critical Analysis and Proposals for Reform*, *supra* n. 13.
43. Assessment and collection issues are closely linked, as tax collection obligations cannot be satisfied if the questions as to what amount to collect and where to remit it could not be answered correctly. The specific issues related to tax collection, however, are beyond the scope of this chapter, as they are addressed in another chapter of this book.

– where consumption takes place. In the context of e-supplies, however, the question may be raised as to whether any deviation from the traditional proxy of the place of residence/business of the e-customer is at all relevant. First, considering different proxies depending on the factual circumstances surrounding each e-supply seems unrealistic. Concerning supplies to non-taxable customers more specifically, it seems unrealistic to expect that e-suppliers take into consideration, for example, the fact that a private customer may be spending the majority of his or her time in a jurisdiction where he or she is not officially resident, or the fact that such person could be purchasing e-supplies from his or her smartphone while travelling abroad. Moreover, it would seem that the related compliance burden (including determining, for each supply, whether an alternative proxy or the standard proxy should apply) is also quite disproportionate to the relatively low number of cases in which a non-taxable person is actually spending most of his or her time at such person's second residence or is making purchases from a jurisdiction in which he or she is not officially residing, and the question may be raised as to whether it is really sound to introduce alternative proxies to cover these cases. In that respect, one should bear in mind that proxies are nothing more than predictions as to where a supply is likely to take place because real consumption tests are not achievable or manageable. But even in the case of conventional commerce, their application does not always result in taxation where consumption takes place, and 100% accuracy should therefore not be an objective.

Second, the assumption that it would be economically relevant to apply these alternative proxies can also be challenged. Why, for example, provide that a customer, who resides in Country *A* and, while travelling in Country *B*, purchases from a supplier located in Country *C*, should be paying VAT to Country *B* where he *might* be consuming the acquired supply? For example is it economically relevant that a French e-customer downloading a movie from a UK e-supplier while sitting in a Spanish airport, waiting for a connecting flight to Argentina, where he will watch the movie (or part of it), be required to pay Spanish VAT on his purchase? And is it worth introducing an exception to the traditional proxy of the place of residence of the customer to reach that objective? Would not it be more sound, from a tax policy perspective (including from an administrative perspective), to provide that the tax due on that supply should accrue to France, in the same way as if the customer had downloaded this movie from home before his departure? Going one step further, can it be said that the customer was in Spain when purchasing, or is that an overly conservative approach to the digital economy? Rather, should not it be said that the customer was on the e-marketplace and that, in accordance with a traditionally recognized tax allocation principle, the tax levied on the customer's consumption expenditures should accrue to his or her state of residence? Based on the above, because allowing states to tax the consumption expenditure of their own residents is sound from an economic perspective, and because the use of an alternative proxy does not guarantee taxation of consumption where it effectively takes place while also imposing insurmountable compliance burdens and costs, it seems advisable that the place of residence of non-taxable e-customers be the only proxy to be taken into consideration.

Similar conclusions can be drawn regarding supplies to taxable e-customers, for which it is suggested that the place of business be the only proxy to be taken into

consideration, with the exception that a general anti-fraud provision be foreseen to allow states to ignore wholly artificial constructions.[44] Another nuance is that in the case of supplies to multiple-location customers, it seems more relevant to seek to determine where consumption will take place, for example when a multiple-location taxable person relies on a paying entity for purchases made by any entity of the company. However, even in this case, the proxy of the place of business should apply, and the responsibility to determine which entity will, ultimately, use the supply should not rest on the shoulders of e-suppliers. It is rather the customer who should be liable to make the correction, for example under the recharge system proposed in the OECD International VAT/GST guidelines for B2B supplies of services and intangibles (2014) discussed above.[45]

The next question concerns how and by what means e-suppliers could ascertain the status and residence/place of business of their e-customers in a straightforward and reliable manner for the purpose of charging them the correct amount of VAT, bearing in mind that e-customers can be located anywhere in the world (as e-supplies can be delivered anywhere without delay or transport constraints/costs). As noted, while considering that customer self-identification combined with transaction-based verifications by the e-supplier was the best option available for the short term, the OECD recommendations on e-commerce encouraged states to investigate alternative technology-based solutions for the longer term. The reliance on trusted third parties or on digital certificates were, in particular, identified by OECD Working Party No. 9 as promising routes in its 2001 report.[46] Against this background, it is suggested here that two technology-based approaches deserve further attention, along the following (broad) lines.[47]

First, as financial institutions around the world are increasingly required to collect, store and update information concerning their customers (so-called know-your-customer obligations), it could be possible to use these data in the context of an automated (software-based) tax assessment procedure at the stage of the electronic payment (with a specific procedure to cover cases in which the e-customer uses e-cash

44. The application of such a measure should take place only at the stage of the audit procedure, however, as it cannot be required that suppliers determine whether a taxable e-customer is using such a construction.
45. OECD, *International VAT/GST Guidelines*, at 28.
46. OECD, Working Party No. 9, *supra* n. 4, at 8 ('12. In the medium term, particularly in the context of collection mechanisms for B2C transactions, technology-based options (of which there are several variants, including some which would rely on a trusted third party and/or the use of digital certificates) offer genuine potential'.). The issues of tax assessment and collection are closely linked, and if this chapter focuses on tax-related issues, it should be noted that a significant part of tax collection issues would actually be solved if appropriate assessment mechanisms were found, i.e., if supplier can ascertain what to collect and where to remit it in a straightforward and timely fashion.
47. Two concrete and detailed proposals are made along these lines in Lamensch, *European Value-Added-Tax in the Digital Era: A Critical Analysis and Proposals for Reform*, *supra* n. 13. The first proposal was already sketched in Lamensch, *Unsuitable Place of Supply Rules for Electronic Services in the EU*, *supra* n. 41, and the two were developed in Lamensch, *Are 'Reverse Charging' and the 'One-Stop-Scheme' Efficient Ways to Collect VAT on Digital Supplies? supra* n. 41 in greater detail (yet, not explained and discussed with as much detail and refinement as in the Ph.D. dissertation). They also cover collection issues.

and the like, based on tagging technology, which would still guarantee the anonymity of the currency). Current technology would allow ensuring the confidentiality of the data and the automation of the assessment process. A small remuneration of banks could, among other things, be foreseen for their participation (i.e., for introducing the assessment software into their payment systems), together with a strict limitation of their liability.[48]

Second, as electronic identification devices are developing in a growing number of jurisdictions, the reliable and instantaneously available information stored on these devices could also be used for tax assessment purposes. Again, current technology would allow ensuring that only the relevant information be communicated for tax assessment purposes and, the other way around, that no information related to the purchases effected by the e-customer be stored on the identification device.[49]

The core idea in both cases would be to automate the assessment (and collection)[50] of the tax on the basis of information already collected by banks (in the first case) or stored in official identification devices (in the second case). This means that, in practice, the proposed approaches can be expected to increase the reliability and simplicity of tax assessment (and collection) procedure(s); to reduce the overall tax compliance costs for the supply side – in particular once the set-up costs have been incurred; and to reduce possibilities of tax avoidance, thus increasing the revenue intake.

§2A.04 APPLYING REDUCED VAT RATES TO E-SUPPLIES: THE CASE OF BOOKS VERSUS E-BOOKS

Economists usually agree that single-rate consumption tax systems are least distortive and therefore most desirable. In spite of this, most VAT systems do provide – whether

48. In Lamensch, *European Value-Added-Tax in the Digital Era: A Critical Analysis and Proposals for Reform*, *supra* n. 13, it is suggested that the obligation to subsequently collect the tax could either be left on suppliers' shoulders or could be shifted to banks. The latter option offers a much higher level of protection against fraud and requires a relatively low level of international cooperation for its implementation (essentially because in the great majority of the cases, the tax would not leave the taxing jurisdiction). Financial institutions are already collecting taxes for states (e.g., savings tax, financial transactions tax), and states would be perfectly justified in requiring banks to also assist in the assessment and collection of VAT because reliable information is already in their hands, whereas e-suppliers do not have access to reliable and instantaneously verifiable information in the specific context in which they operate. This having been said, it is clear that a fair remuneration and strict limitation of their liability would be essential.
49. In Lamensch, *European Value-Added-Tax in the Digital Era: A Critical Analysis and Proposals for Reform*, *supra* n. 13, it is suggested that the obligation to subsequently collect the tax could be left on suppliers' shoulders or be shifted to a global tax administration, the latter option offering a much higher level of protection against fraud and substantially reducing the need for international cooperation with non-participating states (essentially because the tax would not transit via the jurisdiction of the supplier anymore).
50. *Supra* n. 43 and n. 46. Assessment and collection are closely linked and beyond the need to streamline the remitting process, the questions as to what to collect and where to remit it should first be settled.

for social, technical or administrative reasons – for the application of reduced rates to selected conventional supplies. With the development of e-supplies, however, the question has arisen as to whether some of these supplies should not also be entitled to reduced rates. A typical case study concerns books and e-books, and the question is whether e-books should benefit from reduced rates in the same way as books and other printed materials. The question is stirring up passions, and many seem to consider that applying a standard rate of VAT to e-books while applying a reduced rate to books is simply discriminatory. Against this background, this section seeks to clearly identify and briefly discuss the different reasons why e-books should or should not benefit from reduced rates.

From a tax policy perspective, one should consider the question as to whether e-books would deserve to be subject to a reduced rate of VAT, as e-books are a medium for culture and knowledge based on technological progress, and this new type of product would therefore perhaps deserve a low tax burden so as to encourage consumption. It can also be argued that providing for the application of a reduced rate of VAT to e-books is a matter of consistency in those jurisdictions where books are subject to a reduced rate. In fact, if a legislature decides that the consumption of literary works deserves an incentive in the form of a reduced rate of VAT, it would seem logical to apply such a reduced rate to all forms of literary works (e.g., books, audio books and e-books), irrespective of whether the different forms of literary works are similar/comparable or in competition (which is a different question that will be discussed, below). However, it can also be argued that applying reduced rates to e-books would actually provide tax savings mainly to higher income households (who are, in the great majority of cases, those who purchase e-books) and would therefore be unsound from a tax policy perspective because it contradicts the traditional ability-to-pay principle. More generally, broadening the scope of application of reduced rates is not desirable when the objective is usually rather to narrow down their scope, or even abolish them.

Another question that ought to be raised is whether applying a reduced rate of VAT to e-books would be essential for the e-book industry to develop or survive, as e-books are typically much cheaper than books, and the margins of e-book publishers are very low. Again, this is a question of tax policy, and it can be argued that production costs for e-books are much lower than for books, so that applying a standard tax burden to the former would be entirely justified. It could then be objected that the costs that must be incurred upfront by e-books publishers in launching their business are very substantial, and that reduced rates of VAT would be necessary to increase their margins to a reasonable level while at the same time supporting start-up costs and allowing the sector to develop (or even survive). Once again, this is a question of tax policy, to which there is no absolute right or wrong answer.

Finally, a blockbuster argument for the application of reduced rates to e-books is based, not on tax policy arguments, but on the legalistic assertion that this would be the only way to comply with the principle of equal treatment and the prohibition of tax discrimination (which essentially prohibits subjecting a situation to a less favourable

tax treatment as compared to the treatment of another, similar, situation).[51] It is indeed quite commonly argued that books and e-books are similar supplies and that, therefore, the application of different tax rates would be discriminatory, even if the question as to the similarity of books and e-books (which is the first and probably most delicate question to settle in a discrimination analysis) has not yet (to the author's knowledge) been the subject of detailed discussion in the literature.[52] As a preliminary remark, this argument seems to be exclusively used with respect to e-books and not with respect to other digital products, such as drawing software for children, compared to children's drawing pads which may be subject to reduced rates (e.g., in the EU). No claim is made either regarding the hardware that is necessary to read an e-book (e.g., a tablet or Kindle). Finally, it is also striking that the application of different place-of-taxation rules for books and e-books (e.g., in the EU under the distance sales legislation) is not regarded as discriminatory either, although they may result in the application of different rates.

Although simple in appearance, the principle of equal treatment and the prohibition of discrimination are complex in their implementation, in particular concerning the way in which the concept of similarity should be interpreted and applied. The question as to whether applying different VAT rates to books and e-books is discriminatory may therefore not be answered in the abstract for all jurisdictions, but ought to be analysed in light of the relevant rules that apply in each legal system and their specific objectives.[53] In the EU, on which the remainder of this section will focus, the question has not yet been settled by the Court of Justice of the European Union (ECJ or the Court),[54] but a relative consensus seems to emerge that the current non-applicability of reduced rates to electronically supplied services[55] is a breach of the EU VAT principle of fiscal neutrality.[56] However, in view of the objective and scope of this

51. And while there is no absolute right of wrong answer to a tax policy question, the question as to whether a situation is legal or illegal (discriminatory or not in this case) should receive a clear cut answer.
52. E-publishing sector reports and statements unsurprisingly all claim that not applying reduced rates to e-books is discriminatory, although without further discussion.
53. And if the applicable non-discrimination rules in a given jurisdiction do not prevent the application of different VAT rates to books and e-books, only tax policy type arguments (such as those briefly discussed, above) should be relied on to advocate for the application of reduced rates to e-books in that jurisdiction.
54. See the two infringement procedures launched by the Commission against France and Luxemburg (Case C-479/13 and C-502/13, respectively) which are still pending and which concern the application of reduced rates to e-books by these two Member States in breach of Article 98(2) of the VAT Directive (causing substantial distortions of competition in favour of those two Member States).
55. In accordance with Article 98(2) of the VAT Directive, which provides that 'The reduced rates shall not apply to electronically supplied services'.
56. There is as yet (to the author's knowledge) no in-depth analysis of the question in the literature. The European Commission Green Paper on the Future of VAT states that 'there are still inconsistencies in the VAT rates applied to comparable products or services'. European Commission, *Green Paper on the Future of VAT: Towards a Simpler, More Robust and Efficient VAT System*, COM(2010) 695 final, at 15. While this thus relates to the argument (mentioned above) that all forms of *literary works* should probably, and for the sake of consistency, be subject to similar rate rules, the Green Paper then adds that 'For instance, Member States may apply a reduced VAT rate to certain cultural products but have to apply the standard rate to

principle (which should be clearly distinguished from the tax policy arguments discussed above), and based on the analysis of ECJ case law, it is suggested here that this is not the case.

EU VAT legislation does not expressly prohibit VAT-related discrimination within a domestic system, but over the years, the ECJ has developed its case law on fiscal neutrality, which is meant to be a reflection of the EU general principle of equal treatment in the field of VAT.[57] As the principle of fiscal neutrality is based on a body of ECJ case law, it is not as clearly defined as if it were enshrined in a specific provision of a Treaty or a Directive. From an analysis of the Court's case law, its basic underlying objective seems to be the prevention of VAT-related distortions, or the idea that VAT rules must, indeed, be neutral and not favour the consumption of one supply over another (and hence not discriminate against one product over another). As illustrated in the Court's case law, this may happen either between similar supplies or between non-similar supplies that are nevertheless in competition so that a different tax treatment would be likely to affect consumption decisions (and therefore be not neutral).

In a first series of decisions, the Court indeed uses the traditional formula that 'the principle of fiscal neutrality prevents the different treatment of similar supplies which are thus in competition with each other', but does not effectively assess the competitive relationship between the supplies at stake, relying solely on the similarity of the supplies. In *Commission v. Germany*, for example, the Court held that the application

competing on-line services such as e-books and newspapers', and uses the term 'discrimination' to qualify that situation, which is a legalistic (as opposed to tax policy) argument that should be used with care. However, the Green Paper, unfortunately, does not further discuss the question of similarity/comparability (and a question that, as mentioned above, should be answered in light of the applicable non-discrimination provision). The European Commission Working Document accompanying the Green Paper does not use the term 'discrimination', but again refers to consistency and to the fact that books and e-books would be 'competing products', but again without further discussion. European Commission, *Commission Staff Working Document, Accompanying Document to the Green Paper on the Future of VAT: Towards a Simpler, More Robust and Efficient VAT System*, COM(2010) 695 final, at 67. In 2013, and in the context of the infringement procedure launched by the European Commission against France and Luxembourg following their decisions to apply a reduced rate of VAT to e-books, Commissioner Semeta stated: 'One of the guiding principles of the ongoing revision of VAT rates is that similar goods and services should be subject to VAT at the same rates and that technological progress should be taken into account' (http://europa.eu/rapid/press-release_IP-13-137_nl.htm). Commissioner Semeta did, however, not delve into the question as to whether books and e-books are effectively *similar*. It is also noteworthy that the European Commission previously clearly considered books and e-books as being different products. See European Commission, *Report from the Commission to the Council on Council Directive 2002/38/EC of 7 May 2002 Amending and Amending Temporarily Directive 77/388/EEC as Regards the Value-added-tax Arrangements Applicable to Radio and Television Broadcasting Services and Certain Electronically Supplied Services*, *supra* n. 11, at 15.

57. DK: ECJ, 29 October 2009, Case C-174/08, *NCC Construction Danmark A/S v. Skatteministeriet*, paragraph 41 (and case law cited); BG: ECJ, 19 December 2012, Case C-549/11, *Orfey Balgaria*, paragraph 34 (and case law cited). Neutrality in the field of VAT also refers to the need to relieve suppliers entirely of the burden of the VAT payable or paid in the course of all their economic activities. See DE: ECJ, 15 November 2012, Case C-174/11, *Zimmermann*, paragraph 47. This is an aspect of neutrality that will not be discussed here.

of a reduced rate of VAT on services provided by musical ensembles (both directly to the public and for a concert organizer), but only on services provided by soloists directly to the public (and not to soloists working for an organizer) was a breach of fiscal neutrality,[58] simply because: 'there is nothing to suggest that the services of soloists and musical ensembles are not similar […] if not identical', and without assessing the competitive relationship between services provided by soloists and musical ensembles.[59]

In *Solleveld*,[60] the Court concluded[61] that excluding certain specific medical care activities carried out by physiotherapists, while the same activities carried out by doctors or dentists were exempt, is a breach of neutrality, provided that the national court determines that they are of equivalent quality,[62] again without reference to a possible competitive relationship between these activities. In these cases, therefore, the Court limited its analysis to the question as to whether the compared supplies are similar, without addressing explicitly the question as to whether these supplies would be in competition with each other.

In *The Rank Group* case, after recalling that: 'the principle of fiscal neutrality precludes treating similar goods and supplies of services, which are thus in competition with each other, differently for VAT purposes',[63] the Court clarified that two supplies are to be regarded as similar for the purpose of fiscal neutrality 'where they have similar characteristics and meet the same needs from the point of view of consumers, the test being whether their use is comparable, and where the differences between them do not have a significant influence on the decision of the average consumer to use one […]'[64] or the other.[65] On that basis, the Court held that bingo machines could not be treated differently for VAT purposes depending on the amount of the stake and prize, and that slot machines should be treated similarly irrespective of how the element of chance in the game is provided (i.e., by software or an electronic random number generator).[66] In the Court's decision, the impact on consumer decisions, and

58. DE: ECJ, 23 October 2003, Case C-109/02, *Commission v. Germany*, paragraphs 19, 20 and 28.
59. *Commission v. Germany* (C-109/02), paragraph 22.
60. NL: ECJ, 27 April 2006, Cases C-443/04 and 444/04, *Solleveld*.
61. After recalling that fiscal neutrality applies to similar supplies 'which are thus competing with each other'. *Solleveld* (C-443/04 and 444/04), paragraph 39.
62. *Solleveld* (C-443/04 and 444/04), paragraph 51. In the same sense, see DE: ECJ, 6 November 2003, Case C-45/01, *Dornier*, paragraph 49.
63. UK: ECJ, 10 November 2011, Joined Cases C-259/10 and C-260/10, *The Rank Group*, paragraph 32.
64. As noted above, this decision concerns supplies of services, but the Court confirmed that it could also apply to goods.
65. *The Rank Group* (C-259/10 and C-260/10), paragraphs 43 and 44, citing FR: ECJ, 3 May 2001, Case C-481/98, *Commission v. France*, paragraph 27. By analogy, NL: ECJ, 11 August 1995, Joined Cases C-367/93 to C-377/93, *Roders* et al., paragraph 27; FR: ECJ, 27 February 2002, Case C-302/00, *Commission v. France*, paragraph 23. The Court also focused on customers' decisions in DE: ECJ, 27 February 2014, Cases C-454/12 and C-455/12, *Pro Med Logistik*, in deciding whether the application of a reduced rate for taxi transport services and of the standard rate for minicab transport services, breached the principle of fiscal neutrality and, in particular, on the question as to whether the differences between the two services 'have a decisive influence on the decision of the average user to use one such service or the other'.
66. *The Rank Group* (C-259/10 and C-260/10), paragraph 20.

therefore the possible distortion of competition, appears very clearly as the underlying decisive criterion ('the differences between them do not have a significant influence on the decision of the average consumer to use one […] or the other').

In its very recent decision in the *K Oy* case,[67] the Court likewise concluded that in order to answer the question as to whether books published in paper form and books published on other physical media (such as a CD, CD-ROM or USB key) are similar from a VAT neutrality perspective, national courts should determine whether these items have 'similar characteristics and meet the same needs, using the criterion of whether their use is comparable, in order to ascertain whether or not the differences between them have a significant or tangible influence on the average consumer's decision to choose one or other of those books'.[68] In this specific case, the Court notably added that:

> the average consumer's assessment is liable to vary according to the different degree of penetration of new technologies in each national market and the degree of access to the technical equipment enabling the consumer to make use of books published on physical supports other than paper, it is the average consumer in each Member State who must be taken as a reference.[69]

In *The Rank Group*, the Court also explicitly added that the actual existence of competition or distortions of competition between two similar supplies does not constitute an independent and additional condition for infringement of the principle of fiscal neutrality.[70] From this decision, one can conclude that, quite logically, when two supplies are similar pursuant to the criteria developed above (e.g., consumer uses), there is automatically a situation where competition exists, and that it is therefore not necessary to further demonstrate this, as 'the similar nature of two supplies […] entails the consequence that they are in competition with each other'[71] and 'the fact that two identical or similar supplies which meet the same needs are treated differently for the purposes of VAT gives rise, as a general rule, to a distortion of competition'.[72] In fact, the Court's decision in *The Rank Group* probably explains why the competitive relationship was not analysed separately by the Court in the case law mentioned above, in which it had decided upfront that the two supplies under scrutiny were similar.

In another series of cases, the ECJ concluded that non-similar supplies which are nonetheless in competition should also be subject to similar VAT treatment. For example in the *A Oy* case, the Court held that the principle of fiscal neutrality does not

67. FI: ECJ, 11 September 2014, Case C-219/13, *K Oy*.
68. *K Oy* (C-219/13), paragraph 31. See also paragraph 25 with reference to *The Rank Group* (C-259/10 and C-260/10).
69. *K Oy* (C-219/13), paragraph 30.
70. *The Rank Group* (C-259/10 and C-260/10), paragraph 34, with reference to *Commission v. Germany* (C-109/02), paragraphs 22 and 23, and DE: ECJ, 17 February 2005, Joined Cases C-453/02 and C-462/02 *Linneweber and Akritidis*, paragraphs 19–21, 24, 25 and 28.
71. *The Rank Group* (C-259/10 and C-260/10), paragraph 33.
72. *The Rank Group* (C-259/10 and C-260/10), paragraph 35, with reference to FR: ECJ, 29 March 2001, Case C-404/99, *Commission v. France*, paragraphs 46 and 47, and UK: ECJ, 28 June 2007, Case C-363/05, *JP Morgan Fleming Claverhouse Investment Trust and The Association of Investment Trust Companies*, paragraphs 47–51.

only apply to 'identical transactions', but more broadly prevents distortions of competition as a result of differing VAT treatment:[73]

> The principle of fiscal neutrality includes the principle of elimination of distortion in competition as a result of differing treatment for VAT purposes. Therefore, distortion is established once it is found that supplies of services are in competition and are treated unequally for the purposes of VAT.[74]

In this type of case where the supplies at stake may not be regarded as similar, demonstrating the competitive relationship is essential because preventing tax-related distortions of competition is what the principle of fiscal neutrality is about. This is not incompatible with the Court's decision in *The Rank Group*, but means simply that the VAT principle of fiscal neutrality – as developed by the Court – concerns both similar and non-similar supplies that are nevertheless in competition, so that a different tax treatment would distort competition by affecting purchasing decisions – which, again, is what the principle of fiscal neutrality prevents.

Notably, the fact that the competition and similarity requirements are not necessarily identical (so that similar products can nevertheless be assumed not to be in competition) is illustrated in *Commission v. France*, in which the Court held that applying a reduced rate solely to supplies of reimbursable medical products and not to non-reimbursable products having the same curative or preventive effect, did not infringe the principle of neutrality because 'once included in the list of reimbursable products, a medical product will, vis-à-vis a non-reimbursable medical product, have a decisive advantage for the final consumer …'.[75] The Court in particular noted that 'it is not the lower rate of VAT which provides the reason for his decision to purchase'.[76] The Court thus focused on the absence of competition between two similar medical products (with the same curative or preventive effect) as a result of the end-price difference caused by the reimbursement,[77] and accepted the different tax treatment which would not affect consumers' purchasing decisions[78] (the latter criteria thus being the decisive one).

Summing up, the principle of fiscal neutrality prevents the application of a different VAT treatment to identical and non-identical supplies which are sufficiently in

73. FI: ECJ, 19 July 2012, Case C-33/11, *A Oy*, paragraph 32, citing DK: ECJ, 16 September 2004, Case C-382/02, *Cimber Air*, paragraph 24, and ES: ECJ, 18 Oct. 2007, Case C-97/06, *Navicon*, paragraph 21.
74. *A Oy* (C-33/11), paragraph 33, citing *JP Morgan Fleming Claverhouse Investment Trust* (C-363/05), paragraph 47 and case law cited therein. In LT: ECJ, 19 July 2012, Case C-250/11, *Lietuvos* (decided the same day), the Court, however, concluded that fiscal neutrality was not breached in the case of different VAT treatment of road and rail transport because the two modes of transport 'are not generally interchangeable and that the situation of undertakings operating in each of those different transport sectors is accordingly not comparable', paragraph 45, without examining the competitive relationship between the two.
75. *Commission v. France* (C-481/98).
76. *Commission v. France* (C-481/98), paragraphs 25 and 27.
77. In this case, reimbursement depended on whether the patient was buying the medical products with or without a medical prescription. This factual difference does not change the fact that the products are similar and that in both cases, the patient buys them to cure or prevent an illness.
78. In this case, therefore, the Court concluded that there was an absence of similarity (and thus prohibited discrimination) because of large price differences.

competition with each other to affect customer purchasing decisions in case of a different tax treatment, and the Court considers that this is automatically the case when two supplies 'have similar characteristics and meet the same needs from the point of view of consumers'. In other words, it quite simply requires that VAT legislation remain neutral on trade and not favour one type of supply over another. In both cases, consumer preferences and end-uses are key elements.

Based on the above, and for the purpose of the question as to whether the application of a different VAT rate for books and e-books would infringe the EU VAT principle of fiscal neutrality, the relevant question is therefore whether books and e-books are to be considered as either similar or in competition from the perspective of the consumer so that a different VAT treatment would be likely to favour the consumption of the least taxed supply over a similar, higher taxed supply.

Although a book and an e-book tell the same story, their different formats and functionalities admittedly render them not similar products from a consumer perspective:

- the consumer buying an e-book must also buy a reader or a tablet in order to be able to read it (while a physical book does not come without the paper on which it is printed);
- an unlimited number of e-books can be stored without taking any physical space, which is not the case with paper books;
- an e-book may be purchased over the Internet, at any time of the day or week and in different languages, and it is immediately delivered no matter where the chosen supplier is located. In contrast, if a customer wants to read a paper book that is available in the original language only in a faraway jurisdiction, the customer will have to wait, and will have to pay extra fees for shipping;
- additional functionalities are also available in the case of e-books, such as word search functions, or the possibility to change the font and size of the text or to share ratings and commentaries on the e-books with other users all over the world. In contrast, paper books may be preferred for their format,[79] for reasons of colour, graphics or the need to navigate in a non-linear manner – a style to which e-book readers are not well adapted;[80] and
- an e-book may traditionally be downloaded only once by the customer on the customer's reader and is not transferable, so that it can only be borrowed if the user borrows the device on which it is stored (hence, together with the entire virtual library of the customer).[81] Related to this is the fact that an e-book often gives the consumer only the right to use a product as a licensee (while giving

79. H.I. Chyi & A.M. Lee, *Theorizing Online News Consumption: A Structural Model Linking Preference, Use, and Paying Intent*, paper presented at the 13th International Symposium on Online Journalism, Austin, Texas, 20–21 April 2012, at 4 (concluding, based on several surveys made in the United States, that readers have a clear preference for printed rather than online newspapers).
80. D. Bounie et al., *Superstars and Outsiders in Online Markets: An Empirical Analysis of Electronic Books*, Electronic Commerce Research and Applications 12 (2013), at 52, 53.
81. The terms and conditions of the licence agreement may actually restrict the right of the customer to share his or her e-books with other users.

the licensor the right to take the product back),[82] whereas a book gives the consumer full property rights. A paper book is indeed owned by the consumer, remains available, can be borrowed by others and does not suffer from technical and mechanical constraints (e.g., does not need to be charged like a tablet or reader).

These respective specifics and functionalities admittedly make books and e-books different supplies from the perspective of satisfying consumer needs.

Interestingly, in its 2003 report, OECD Working Party No. 9 noted that OECD member countries 'largely take the view that the different functionality inherent in the online version means that, typically, the electronic product is significantly different from its hard copy version'.[83] In the same fashion, in its 2006 report to the Council, the European Commission noted that '[e]lectronic publication opens the door to range of functionalities which give a service increasingly removed from traditional printing and rather in the mainstream of general electronic communication and distribution'.[84] In addition, e-books are traditionally sold at a much lower price than books, which may a further confirmation that books and e-books are different products that cannot be sold at the same price to customers.

Considering that books and e-books may thus not be considered as similar products, the next question concerns whether they are in competition and – more importantly – whether a different tax treatment would be likely to influence customer purchasing decisions, thereby breaching the EU VAT principle of fiscal neutrality (which question would not have to be discussed if the two products were similar, as in such case they would automatically be in competition). In fact, and in view of the objective and scope of the EU VAT principle of fiscal neutrality, the relevant question to determine whether a different tax rate for books and e-books represents a breach of the principle of fiscal neutrality, should indeed not be whether customers are switching

82. See e.g., the Apple Store terms and conditions, which clearly provide that 'The Products transacted through the Service are licensed, not sold, to You for use only under the terms of this license' (full text available at https://www.apple.com/legal/internet-services/itunes/appstore/dev/stdeula); the Kindle Store terms of use: 'Upon your download of Kindle Content and payment of any applicable fees (including applicable taxes), the Content Provider grants you a non-exclusive right to view, use, and display such Kindle Content an unlimited number of times, solely on the Kindle or a Reading Application or as otherwise permitted as part of the Service, solely on the number of Kindles or Supported Devices specified in the Kindle Store, and solely for your personal, non-commercial use. Kindle Content is licensed, not sold, to you by the Content Provider' (full text available at https://www.amazon.com/gp/help/customer/display.html/ref=hp_left_v4_sib/188-4885339-9649828?ie=UTF8&nodeId=201014950); the Microsoft retail licence terms: 'We do not sell our software or your copy of it – we only license it. Under our license we grant you the right to install and run that one copy on one computer (the licensed computer) for use by one person at a time, but only if you comply with all the terms of this agreement' (full text available at http://office.microsoft.com/en-us/products/microsoft-software-license-agreement-FX103576343.aspx).
83. OECD Working Party 9 Report 2003, see *supra* n. 4, p. 25.
84. European Commission, *Report from the Commission to the Council on Council Directive 2002/38/EC of 7 May 2002 Amending and Amending Temporarily Directive 77/388/EEC as Regards the Value-added-tax Arrangements Applicable to Radio and Television Broadcasting Services and Certain Electronically Supplied Services*, *supra* n. 11, at 15. The position of the European Commission on that question may have changed. *Supra* n. 56.

from books to e-books irrespective of the driver for such a trend, but whether the decision to buy a book or an e-book is likely to be influenced by a different tax treatment of these two products (which, in that case, would mean that the tax rule is not neutral), or whether the different specifics and functionalities that books and e-books offer, are decisive for customer decisions, and unlikely to be affected by a different tax treatment.

It is often argued that books and e-books are competitive products. However, the few cross-price elasticity studies available do not reach unanimous conclusions regarding the substitutability of these products.[85] Bounie et al., for example, find a high cross-price elasticity between books and e-books, albeit only for the top-selling print books.[86] In contrast, Hu and Smith find a negative cross-price elasticity between books and e-books, which suggests that the two products are complements.[87] Further economic studies should therefore perhaps be conducted. In addition, as the core of the question concerns consumer preferences, an EU-wide assessment of consumers and industry perceptions and valuations would also be welcome. In that regard, in its recent decision in the *K Oy* case concerning books as compared to e-books supplied on a tangible carrier, the Court held that:

> the average consumer's assessment is liable to vary according to the different degree of penetration of new technologies in each national market and the degree of access to the technical equipment enabling the consumer to make use of books published on physical supports other than paper, it is the average consumer in each Member State who must be taken as a reference.[88]

In the absence of conclusive economic studies, markets definitions in competition cases can be instructive.[89] In the context of a price fixing complaint against Apple and several publishers concerning the sale of e-books, the US Department of Justice concluded that 'no reasonable substitute exists for e-books'.[90] This statement was based on three very specific technical features of e-books mentioned above, namely their storability (thousands of e-books 'can be stored on a single small device'), compatibility with electronic devices (e-books can be 'read on electronic devices, while print books cannot') and accessibility ('e-books can be located, purchased, and

85. In that sense, see H.A. Kogels, *VAT @ e-commerce*, 8 EC Tax Review 2 (1999), at 117; Bounie et al., *supra* n. 80, at 52.
86. Bounie et al., *supra* n. 80, at 57.
87. Y. Hu & M. Smith, *The Impact of Ebook Distribution on Print Sales: Analysis of a Natural Experiment* (2013), available at http://ssrn.com/abstract = 1966115 and http://dx.doi.org/10.2139/ssrn.1966115.
88. *K Oy* (C-219/13), paragraph 30.
89. Market definitions are used in competition cases to identify the boundaries of competition between seemingly related products. See EU: *Commission Notice on the Definition of Relevant Market for the Purposes of Community Competition Law*, OJ C 372 (9 December 1997), at 0005-0013 ('The relevant market in terms of product comprises all those products and/or services which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use'.).
90. US: DC S. Dist. N.Y., *United States v. Apple, Inc., Hachette Book Group, Inc., HarperCollins Publishers L.L.C., Verlagsgruppe Georg Von Holtzbrinck Gmbh, Holtzbrinck Publishers, LLC D/B/A Macmillan, The Penguin Group, a Division of Pearson PLC, Penguin Group (USA), Inc., and Simon & Schuster, Inc.* (anti-trust case).

downloaded anywhere a customer has an internet connection, while print books cannot').[91] The conclusion of the Department of Justice was also supported by the fact that the defendants in the case 'view e-books as a separate market segment from print books'.[92] In the EU, the Directorate-General for Competition never used such clear terms, but nevertheless also concluded in several cases that publications in conventional or electronic forms are distinct product markets.[93]

Another noteworthy fact is that the majority of supplies in basically all sectors, including in the publishing industry, are still made in a conventional manner, in spite of traditionally lower prices for e-books (as noted above). The Global Digital Media Trendbook (2013), for example, reports a fivefold increase in sales of e-books from 2011 to 2015, but notes that e-books still represent a tiny fraction of all books sold worldwide.[94] These figures show that e-books, which have now been available for many years, have not replaced printed books in spite of lower prices (and actually remain a small fraction of the publishing industry sales), which could confirm that a competitive relationship may not exist between books and e-books, and – more importantly – that a significantly lower price for e-books (in spite of a higher tax burden) does not affect consumers' purchasing decisions, which seem to be mostly driven by the respective specifics of books and e-books. Otherwise, a natural shift would have occurred towards an exclusive consumption of e-books.[95]

Based on the above, the conclusion is drawn that further research is needed to assess the possible distortive effect of a different tax treatment of books and e-books

91. *US v. Apple* et al., Complaint, at 33, available at http://www.justice.gov/atr/cases/f282100/282135.pdf.
92. *Id.*
93. See e.g., Commission Case COMP/M.2978, 7 January 2004, *Lagardère/Natexis/VUP*; Commission Case COMP/M.1377, 15 February 1999, *Bertelsmann/Wissenschaftsverlag Springer*, in which the Directorate General Competition stated that the development of new distribution means for publications, in electronic form through CD-ROMs and through online websites, are regarded as a separated medium of distribution by market participants. In Commission Case COMP/M.6789, *Bertelsmann/Pearson/Penguin Random House*, in which, as part of its market investigation regarding the sale of English books to dealers, the Directorate carried out a consultation exercise with publishers and customers and found that 'the majority of responding customers consider that the vast majority of consumers would not switch from print books to e-books and vice-versa in case of a 5 to 10 per cent increase in the retail price'. Finally, in the merger procedure involving UK-based APW, GMG and EMAP, the Directorate General Competition did not consider alternatives to publication in print when defining the relevant readers' market. However, in defining the market for advertising space (which it finds constitutes a separate market), it does include the sale of online advertising space.
94. World Newsmedia Network, *Global Digital Media: Trendbook 2013*, at 7.
95. Still as regards the different price of books and e-books, bear in mind that in *Commission v. France* (C-481/98), the ECJ considered that a price difference was, in itself, a sufficient element to determine that two medical products (which were identical in substance) are not similar for VAT purposes, because this difference alone is enough to drive consumers' choices and that, as a consequence, a different tax treatment does not breach the principle of fiscal neutrality, the objective of which is to prevent tax-related distortions. In light of this Court decision, and applied to the present case study, one could argued that, in addition to very different prices which already suppresses competition between them, books and e-books are different products having different characteristics and end-uses – which are the elements that influence consumers' choices, and that because of their differences, a different tax treatment is not likely to influence consumers' purchasing decisions, and therefore does not breach the principle of fiscal neutrality.

(including, in particular, EU-wide consumer and industry perception and valuation surveys). In the meantime, and contrary to what is commonly argued, it is further suggested that the respective characteristics of books and e-books are so different that they are decisive on consumer purchasing decisions, and that a different tax treatment of these respective items is not likely to affect consumer decisions and, as a consequence, to breach the EU VAT principle of fiscal neutrality.

Accordingly, the general conclusion for this section is that it can be argued that e-books should be subject to reduced VAT rates in the EU on the basis of tax policy arguments such as the cultural merit of e-books and the need for consistent tax policies,[96] or the need to support the e-book industry, but not on grounds of fiscal neutrality.

§2A.05 CONCLUSION

This relatively brief overview of the three basic questions, namely: (i) how e-supplies should be characterized and defined for VAT purposes, (ii) where they should be taxed and how tax assessment can be performed in a digital context and (iii) whether some such supplies should be subject to reduced VAT rates, leads to the following conclusions.

First, e-supplies should be characterized/defined in a way that allows for the application of tailored and appropriate rules where needed. It was suggested that the better way to achieve this objective would be, on the one hand, to characterize all such supplies as intangibles together with services rendered conventionally, as opposed to goods or real property and, on the other hand, to provide for the application of specific rules, where needed, to those supplies that are rendered on an entirely remote basis via the Internet or an electronic network.

Second, e-supplies should all be taxed at destination, at the place of residence/business of the customer without exception, as (i) an origin-based taxation creates serious distortions in a digital context and (ii) relying on several proxies under a destination-based system proves overly complicated. The latter is true particularly in light of the very limited number of cases in which alternative proxies would actually be applicable, and because – upon closer examination – the use of multiple proxies does not seem so relevant from an economic perspective. The question of customer identification and location for tax assessment purposes cannot be approached in the same manner as in the sector of conventional supplies of services. In particular expecting that e-suppliers should proceed to transaction-based verifications on the basis of different indicators from different sources depending on the factual circumstances surrounding each e-supply is not reasonable in a digital context, no matter how specific the legislature can be regarding the type of information that should be processed, essentially because it imposes an insurmountable compliance burden on

96. In that case, instead of simply broadening the scope of authorized reduced rates to 'e-books' and run the risk that other forms of cultural and knowledge mediums develop that would again not be covered, the EU legislature could perhaps rather decide to authorize the application of a reduced rate of VAT to any form of *literary work*.

e-suppliers still without ensuring legal certainty, and because it also does often not allow tax administrations to verify that VAT has been correctly assessed at the stage of the audit.

This may have been the best way out for the short term when the digital economy started to develop, but the time has now come to think about the long-term. Following the recommendation made early on by OECD Working Party No. 9, that technology-based solutions be developed to tackle the question of e-customer identification and location, it was then suggested that two approaches that would deserve further attention would be to automatize the VAT assessment process, either on the basis of reliable and immediately available information regarding e-customers that is already collected by banks in the context of their know-your-customer obligations, or on the basis of the data stored in a growing number of jurisdictions on citizens' electronic identification devices.

Third, there are many reasons why it would be commendable for e-books to be subject to reduced VAT rates in the same way as books, including the facts that e-books are a medium for culture and knowledge and would therefore deserve preferential tax treatment, or that it would be more consistent from a tax policy perspective, or that applying a reduced rate of VAT to e-books is essential for the e-book industry to develop (or even to survive), as the start-up costs are very substantial and reduced VAT rates could allow e-publishers to maintain reasonable margins.

However, there are also several reasons why it would not be desirable, from a tax policy perspective, to apply reduced rates to e-books, including because the application of reduced rates to e-books would actually provide tax savings mainly to higher income households, as production costs for e-books are much lower than for books, so that the application of a standard rate of VAT to e-books could be justified or, more generally, because broadening the scope of reduced rates is not desirable when the overall objective should rather be to narrow down their scope or even to abolish them.

In any case, the non-applicability of reduced rates to e-books does not breach the EU VAT principle of fiscal neutrality, which seeks to prevent tax-related distortions, and which therefore prohibits different VAT treatment of similar supplies or of non-similar supplies that are nevertheless in competition so that a different tax treatment thereof would be likely to distort trade by affecting consumer purchasing decisions. The argument is that books and e-books have different formats and functionalities, so that they cannot be considered as similar, and that in spite of an often alleged (yet not always demonstrated by economic studies) competitive relationship between books and e-books and the growing number of sales of e-books, consumer decisions to buy a book or an e-book are in fact driven by a multitude of reasons that are not likely to be influenced by a different tax treatment. In other words, if strong (tax policy) arguments can be developed in favour of the application of reduced rates for e-books in the EU, they should not be based on a (legalistic) VAT neutrality argument.