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TAXATION IN THE ERA OF DIGITISATION

Bachelor's thesis

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I declare that I have compiled the paper independently
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TABLE OF CONTENTS

ABSTRACT	4
LIST OF ABBREVIATIONS	5
INTRODUCTION	6
1. DIGITAL ECONOMY	9
1.1 The digitisation	9
1.2. Forms of digital economy	11
1.3. Goods or Services?	12
2. EU TAXATION POLICY	16
2.1 Harmonisation of EU Taxation	17
2.2. VAT	19
2.2.1 Developments of the European VAT system	20
2.2.2 VAT in the digital economy	21
2.2.3 B2C Transactions: Destination Principle	22
2.2.4 B2B Transactions: Place of Supply Rule and Reverse Charge Mechanism.....	23
2.2.5 MOSS	25
2.3. Applying Reserve Charge Mechanism on B2C Transactions?	26
3. EU VAT COMPARED TO OTHER SYTEMS	29
3.1 New Zealand GST overview	29
3.2 Japanese CT Overview	31
3.3 Common principles in the near future	32
CONCLUSION	36
LIST OF REFERENCES	38

ABSTRACT

The long-continued digitisation has radically modified the way of doing business. However, the taxation systems have been amended to respond this progress only in recent years. This thesis summarises the development of the EU's Value Added Tax (VAT) regime since the era of European Coal and Steel Community (ECSC) at the current days and assesses the impact of on the current regime. Theoretical and empirical literature has been used on the basis to construct an overview of the digitisation as well as the EU's responses like the reverse charge mechanism and MOSS will be evaluated. The comparisons concluded between the EU and New Zealand, one of the members of the Digital 5, as well as between EU and Japan, which has a very experiential taxation system, show the current development in these respective VAT regimes and point out the differences, the positive effects and maladministration that needs to be addressed in order to achieve an effective and fair taxation considering services provided digitally and how the OECD recommendations together with the EU's model could provide solutions. This thesis determines whether the reverse charge mechanism introduced by the EU on transactions between businesses would be applicable also on business to consumer transactions supplied as electronically service and secondly, and whether it could help to ensure the status and the location of the consumer supplying electronically services; hence, the correct applicable rate.

Keywords: Digitisation, Taxation of Electronically Supplied Services, VAT Regimes, Reverse Charge Mechanism.

LIST OF ABBREVIATIONS

B2B – Business to Business

B2C – Business to Consumer

CT – Consumption Tax

GST – Goods and Service Tax

G2C – Government to Consumer

ECSC – European Coal and Steel Community

ICT – Information and Community Technology

MOSS – Mini one-stop-shop

OECD – Organization for Economic Cooperation and Development

VAT – Value Added Tax

INTRODUCTION

Without a doubt, the EU has been influencing European tax policies, particularly in its member states.¹ Since the late-1960s, there has been effective VAT directive, which has been altering and at least partly improving indirect taxation policies around the EU.² Business in Europe has been developing, it is not bordered like it used to be and there are thousand and thousand cross-border transactions concluded on a daily basis. At the same, the digitisation has restructured the common global way of doing business it is more cost-effective for the supplier and opens new possibilities, by offering customers more and more options to purchase their services and goods via variable channels. Purchase options are not restricted by the continents anymore, rather customers may conclude agreements with sellers whether their distance is many thousand kilometres and there is more than one border to cross.

During this era, the collection of taxation has been altered. Due to cross-border transaction, supplier and consumer are not necessarily in the same country, which is causing polemics. In these circumstances, determining the correct place of taxation; and thus, the rates, which may vary depending on the purchasing, is a hard task. This is causing a headache for the companies in the EU as well as companies based outside of it. Closer look will be given on EU's responses on these issues and causals of the definition goods and services effecting on this equation. Due to the nature of these transactions, which are often in form intangible, same sort of controlling cannot be carried out like it has been with the tangible ones. In addition, and fortunately, EU is not only one to struggle with digital taxation, rather these are global challenges, which must be tackled together. This thesis answers whether there is need to have a further and closer international cooperation to have an effective taxation on electronically supplied services and gives a selected overview of the international taxation regimes and which sort of tool may ease the issues.

¹ Terra, B. J. M., Wattel, P. J. (2008). *European Tax Law: Abridged student Edition*. 5th ed. Alphen aan den Rijn: Kluwer Law International. p.5-15.

² *The Economics of the European Union*, (1996). (Eds.) M.J. Martis, N. Lee. New York: Oxford University Press. p. 10-24.

Balancing between international recommendations and its own legislation the EU is required to making sustainable decisions. Although, the EU is considered to be the forerunner of the digital taxation, the current implemented VAT system designed for the more traditional ways of doing business is outdated and it is not capturing activities based on intangible assets and data. The EU has by its latest implementations recognised some of the upheavals in the old basic principles. All in all, the EU is aiming to prevent distorting the competition and improve the position of the European companies. At the same time, it is cutting the amount of bureaucracy, which may be very harmful especially for the Small and Medium Sized Enterprises (SMEs). In the year 2017, while Estonia Presidency of the Council of the European Union, new proposals were introduced which would lead to a fair and effective taxation system to complete Digital Single Market by 2020.³

For the purpose of this thesis, there is emphasise on services in digital forms rather than on goods and the more traditional types of services, which have been left out in the interest of clarity. Concepts and differences of services and goods will be introduced and definition of the digital content to clear the issues raising. Brief introduction about the EU taxation policy's developments will be given and how the harmonisation of indirect taxation in EU has been concluded and which sort of effects may be observed. Also, very short analyse of the other taxation harmonisation will be given to demonstrate the scope of indirect taxation harmonisation. A big part will be covering the issues of the VAT system, how those issues have been addressed by the latest implementations and which sort of alterations may be discovered e.g. the destination principle and reserve charge mechanism. Then the focus will be forwarded on the international aspects and how the globalisation is leading to change in the legislation related to taxation of the digital content. At the end, there will be a comparison between the EU VAT system and New Zealand Good and Service Tax (GST) as well as Japanese Consumption Tax (CT) systems, which have been faced varying challenges related to the European Union. The comparisons reflect the international aspects of the indirect taxation.

Empirical and theoretical literature construct a solid basis for the concluded research. Data has been gathered, by keeping mind academic requirements, and it does reflect the current stage and do show the development since the mid-1990s. The EU legislation is in a major role and it will be

³ European Commission – Press Release: Towards a new and definitive VAT system for the EU. (2017). Accessible https://ec.europa.eu/commission/news/towards-new-and-definitive-vat-system-eu-2017-oct-04_en 1 February 2018

compared to the international recommendations as well as some countries legislation. The EU case law, relevant to the topic, is included to demonstrate the situations and together with the collected data these help to answer following research questions: whether the reverse charge mechanism introduced by the EU on transactions between businesses would be applicable also on business to consumer transactions supplied as electronically service and secondly, and whether it could help to ensure the status and the location of the consumer supplying electronically services; hence, the correct applicable rate.

1. DIGITAL ECONOMY

Digital economy and digitisation of the economy is one of the biggest innovators and positive impactors of economic growth in modern society.⁴ The real globalisation, like it is possible to sense in early the 21st century, would not have been emerged so rapidly without the innovations guaranteed by the digitisation. The progress is only on its early stage, but it has already revolutionised world like electricity.⁵

In the year 1995, new and user friendlier web browser was introduced, which launched the real era of the online activities.⁶ The speed of the development of these activities has been described to be one of the fastest in any sector of the technology. Simultaneously, the Digital Economy has grown on a same enormous speed during the 21st century and it has revolutionised the whole global economy by varying manners of the business and the consumers. It is not an easy task to estimate the amount of business concluded in a digital way but there are some rough estimations that in 2016, the digital economy reached USD 4.2 trillion in G-20 economies.⁷ To demonstrate, in case of digital economy being nation, it would be the fifth largest economy in the world.⁸ Therefore, the importance of the digital economy should not be underestimated in any given scenario.

1.1 The digitisation

Basically, digital economy or e-commerce can be described as an economy, which is in most cases functions by means of digital technology, electronic transactions concluded on the internet.⁹ Essentially, the use of the computer network has to be involved as the main element in transactions, which may involve the production, distribution, sale, delivery of goods or services. However, it is

⁴ Brynjolfsson, E., McAfee, A. (2014). *The Second Machine Age*. 2nd ed. New York: W.W. Norton.p.36-42

⁵ Brynjolfsson, E. (2015) *Open Letter on the Digital Economy*. – MIT Technology Review, 4 June. Accessible <https://www.technologyreview.com/s/538091/open-letter-on-the-digital-economy/> , 15.2.2018

⁶ Cohen-Almagor, R. (2013). Internet History. - Moral, Ethical, and Social Dilemmas in the Age of Technology: Theories and Practice. (Eds.) R., Luppacini, Hersey: *Information Scientific Reference*, p. 20-34

⁷ Expert Group on Taxation of the Digital Economy (2014) *Working Paper: Digital Economy - Facts & Figures* p.4.

⁸ Dean, D. et al (2012). *Working Paper: Digital Economy - Facts & Figures*. – The Connected World. Boston: Boston Consulting Group. p 3-5.

⁹ Expert Group on Taxation (2014), *supra nota* 7, p 4.

more than just selling or buying. For example, electronic data interchange between companies or just business conducting with the customer may be seen as part of the digital economy.¹⁰

There are tons of different applications and those may be varied in a different way. Thus, many new business ideas have been introduced and some of the basic business has been replaced by these new ideas.¹¹ Of course, some of the more traditional enterprises cannot be replaced by the new modes of digital economy. E-commerce can be conducted for example following ways: business-to-business operations (B2B), business-to-consumer transactions (B2C), government to consumer transactions (G2C) or even as consumer to consumer (C2C).¹² So, e-commerce is helping companies interacting between each other as it helps companies to find their customers. In addition, services in the internet are available all the time, not just in limited hours like those brick and mortar stores. On the internet, there are more options available for the consumers and the variety is widespread. After all, the digitisation has been one of the most positive occurring for the global economy.

Currently, roughly 3.5 billion people use the internet¹³ and each one of those users is potential consumer of the digital economy. The internet is not limited or at least most of it. Consequently, everyone living in Paraguay, in Rwanda or in New Zealand may be targeted as a potential customer by the European or Asian companies or vice versa. In the near future, the impact will be growing due to even larger number of users and more variable solutions.¹⁴

Despite the size of the digital economy and its influence, it seems that international jurisdiction has not managed to keep up with the speed of the digitisation, respectively in any field of digital economy. More or less, the jurisdiction is designed for needs of the more traditional businesses. Therefore, examining the tax rules and principles considering digital economy at the EU level is necessary, but it requires international cooperation. Notwithstanding, fair and effective taxation is everyone's interest and without that sort of taxation policy, there is much greater risk of losing those assets.

¹⁰ O'Callaghan, R., Turner, J. A., (1995). Electronic Data Interchange Concepts and Issues. - *Working Paper Series*. (eds.) John Wiley & Son. Center for Digital Economy Research Stern School of Business. p.1-3.

¹¹ Helberger, N. et al. (2013). *Digital Consumers and the Law*. 28th ed. Alphen aan den Rijn: Kluwer Law International. p.2-5.

¹² Cockfield, A., et al. (2013). *Taxing global digital commerce*. 3rd ed. Alphen aan den Rijn: Kluwer Law International. p.25-32

¹³ Statista. (2017). *Number of internet users worldwide from 2005 to 2017* (in millions). [E-Database] Accessible: <https://www.statista.com/statistics/273018/number-of-internet-users-worldwide/>, 20 January 2018

1.2. Forms of digital economy

Ever changing and developing digital environment has provided a platform for the new forms of businesses. Businesses, which are hard to label belonging into any previously existing ones. In some of the cases, it is even hard to really make a difference between whether the digital content is falling within category of goods or services. The variety of forms does not ease the problems concerning taxation in this specific field, rather it makes it even harder to find a proper and sustainable solution. Previously, EU has made clear in directives ¹⁵ that there is only one type of digital content. “Digital content means data which are produced and supplied in digital form, such as computer programs, applications, games, music, videos or texts, irrespective of whether they are accessed through downloading or streaming, from a tangible medium or through any other means” ¹⁶ and digital content has been defined as follow: “data which are produced and supplied in digital form.” ¹⁷ However, the European Parliament and the Council managed to publish their ideas of different business models in late 2017.¹⁸ The list of the examples presented was not exhaustive but presented four different types of doing business in the era of digitisation and shows the spectrum of the models, which may be used to make business, is wider than previously thought. In addition, the list itself and the preparation of it shows that required actions have been taken toward the categorising. These models have been listed in a following way.

First model has been described as follows: “the Online retailer model, whereby online platforms sell goods or connect buyers and sellers in return for a transaction or placement fee or a commission. Examples of businesses include Amazon, Zalando, Alibaba.” ¹⁹

Second one is Social media model: “whereby network owners rely on advertising revenues by delivering targeted marketing messages to consumers. Examples of businesses include Facebook, Xing, Qzone.” ²⁰ This may be the most complicated one due the social media receives big part of their income by gathering users data.²¹ Giving a monetary value for the gathered data is a problematic

¹⁵ Directive 2011/83/EU of the European Parliament and of the Council of 25 October 2011 on Consumer rights, OJ L 304, 22.11.2011. Preamble

¹⁶ *Ibid.*

¹⁷ *Ibid.*

¹⁸ Communication from The Commission to The European Parliament and The Council on A Fair and Efficient Tax System in the European Union for the Digital Single Market. Brussels 21.09.2017. p.5.

¹⁹ *Ibid.*

²⁰ *Ibid.*

²¹ Barbier, G., Liu, H. (2011). Data Mining in Social Media – *Social Network Data Analytics*. (Eds.) C. Aggarwal. Boston: Springer p.328-333

as well as there is no recording of this data in sense of value added taxes.²² Ultimately, some of the VAT revenue is leaking.

Third one is Subscription model: “whereby platforms charge subscription fee for continued access to a digital services (e.g. music or videos). Examples of businesses include Netflix, Spotify, iQiyi.”²³

The fourth and the last one is Collaborative platform model: “whereby digital platforms connect spare capacity and demand, use reputational currency mechanisms to underpin consumption, and enable individuals to share “access” to assets rather than own them outright. Platforms charge a fixed or variable fee on each transaction. Examples of businesses include Airbnb, Blablacar, Didi Chuxing.”²⁴

These models are good examples and show progress. There is necessity to implement these in action, since rules governing taxation have been created mostly in era, when the real effects of the digital economy and forms were not acknowledged, those outdated rules shall not be applied anymore. For instance, there are no applicable tax rules considering intangible assets. Categorising content has been eased with this sort of modelling.

1.3. Goods or Services?

Current EU legislation is giving a reasonable answer as to whether certain transactions shall be considered as services or as goods. However, there are issues with these clarifications and the certain alignment is missing whether service shall be considered as an e-service or as a regular one. This matter could be dealt as matter of own thesis. Therefore, there is need to make a certain limitation at this point and stay at the list provided by the EU.²⁵

²² Maeser P. P., Halsch, V.(2017). Reform of the VAT System in the European Union. - *politik für europa*. (Ed.) M., Meinardus. Berlin: Friedrich Ebert Stiftung. p.8.

²³ Communication from The Commission to The European Parliament and The Council on A Fair and Efficient Tax System in the European Union for the Digital Single Market. Brussels 21.09.2017. p.5

²⁴ Communication from The Commission to The European Parliament and The Council on A Fair and Efficient Tax System in the European Union for the Digital Single Market. Brussels 21.09.2017. p.5

²⁵ List of Electronical Supplied Services. Accessible:

https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/common/buying_online/electronically_supplied_services.pdf , 20 January 2018.

The court has recently adopted a fairly consistent approach to the digital goods. The EU case law has during the 2000's dealt with these clarifications. For instance, when considering purchasing of e-book from an online shop, and customer read it as an e-book, which means that actual physical of that book has not been handed out. The person receiving the book has only access to that database, where the book is locating. In this certain action, there is only transaction concluded on internet, which gives access to read the book locating in the database. Without an investigation, it is hard to define whether this sort transactions shall be labelled as service or shall these be labelled as goods, due to a reasonable person think an e-book just as a regular one. For time being, these are however considered as services, which consist certain distorting. Recently, there has been given a new judgement, which is stating that goods sold on internet as digital form are not in the same level as physically sold goods. According to the EU court, the goods sold in form of digitally cannot be considered as tangible products.²⁶ Therefore, books sold as an e-book is taxed differently when comparing to a physical book, which is applicable to reduced VAT rate.²⁷ Also, there is exemption included in EU case law, which is crucial determine the difference and shows how fine-drawn is the line between goods and services. Levob case shows that software delivered in form of CD discs are considered as goods, but comparable software downloaded from the internet are services.²⁸ Since the amount of goods sold in digital form will be creasing, there is need to rethink these aspects and maybe in the future, those shall be considered to be at the same level as tangible items. The principle of equivalence between digital goods and goods shall be considered as a higher degree.²⁹

In a fact, many of the digital goods are now being listed in an electronically supplied service list, which as launched by EU in 2015.³⁰ This was part of ambitious rule settings for the provider of e-service practising their business in EU to establish VAT rules. The list consists of services, which are delivered over the internet and requires a non or minimal human intervention. Furthermore, it is stating that previously mentioned e-books are considered as services. With this sort of reaction, EU is drifting away from the principle of equivalence between digital goods and goods. Bearing

²⁶ Judgement of 5 March 2015, *European Commission v French Republic*, Case C-479/13, EU:C:2015:141, paragraph 31

²⁷ Hojnik, J.(2015).Digital content as a market commodity sui generis: EU lawyers (finally) moving from Newton physics to quantum physics? - Economic and Social Development - Book of Proceedings. (eds.) Z.Radic, A. Roncevic,L. Yongqiang. Varazdin: Varazdin Development and Entrepreneurship Agency p. 77-79.

²⁸ Judgement of 27 October 2005, *Levob Verzekeringen BV and OV Bank NV v Staatssecretaris van Financiën*, Case C-41/04, EU:C:2005:649, paragraph 30.

²⁹ Schellekens, M. (2006). What Holds Off-Line, Also Holds On-Line? Starting Points for ICT Regulation. – *Law Series* vol. 9. The Hague: TMC Asser Press p.51-75.

³⁰List of Electronical Supplied Services, *supra nota* 25.

in mind, in the future, more and more of the goods are sold in digital form, the problem may have been just moved forward.

These vital points shall be corrected like it has been done in the EU parliament and council's publication, which reflect as adequate for the needs of the 21st century. For instance, purchasing methods of song album may vary in these days. Product may be delivered to the customer by using a regular delivery or then it may be delivered in an electronic form. The recognition of the problem has done but the time to implementing shall be done also correctly. Some points have been maybe intentionally bit unclear, in order to adapt to future developments, which are hard evaluate in forehand and drafting the taxation considering digital economy may be still utmost impossible. There is a distinction made between goods purchased physical and those purchased in their entirety in digital form, rather the line is not that clear. Whether transactions concluded are categorised as goods or services plays in a major role, when considering the calculating of VAT.

Nevertheless, many of the companies are not just operating on one business model rather in some cases they may have distinct models. For instance, Amazon, which use to be only online retailer, provides whole bunch of other services e.g. online video streaming, cloud services, audiobook services, all in all, it has lots to offer on internet nowadays. It has had an impact on collection of the taxes dramatically and has changed the way of doing business.³¹ The story of the Amazon reflects the digitisation at the same time by rapidly growing since mid of 1990 with different digital services. Even though Amazon is US based company, they shall be charging VAT when selling goods and providing services for customers in the EU. Therefore, determining VAT rate once and for all for different types of goods or services is important. Also, different types of cloud computing are providing some interesting challenges, which have to be taken into account while drafting new policies. Basically, those let access for the consumer to enter into their server and is not providing any copy.³² It is certainly closer to a service contract rather than goods supplying contract.³³

Therefore, the further analysis of the models shall take place. Taxation policy requires a systematic and continuous review concluded with the professionals of the field of law as well as definitely with the professionals of the Information and Community Technology (ICT), representatives of different trade business and trade associations. Amending taxation policy for this sort of massive

³¹ Bardopoulos, A. M. (2015). *eCommerce and the Effects of Tecnology on Taxation: Could VAT be the eTax Solution*. 22nd ed. Cham: Springer, p 50.

³² Bradgate, R. (2010). Consumer Rights in Digital Products - A research report prepared for the UK Department for Business, Innovation and Skills. p. 18-20.

³³*Ibid.*

industry will not be an easy task. Denying the fact, that digital economy will be affecting in the future on the global markets, is not a solution rather it shall be tackled soon as possible. With the help of Organization for Economic Cooperation and Development (OECD), there is need to find consensus, at least in its member states, over the varying. Same type of rule set in member states would reduce the pressure.

2. EU TAXATION POLICY

To understand the foundations of the taxation in the European Union, the concept of the European Union, which is very unique, needs to be clarified. In anywhere else, none of the countries have been transmitted part of their sovereignty to coalition or union as the member states of the EU have done.³⁴ There is also need to pay attention to its roots to recognise the fact that it has been an economic community. Since the dawn of the European Coal and Steel Community, later European Community and now European Union, which has been created by ratifying Treaty on European Union on November 1993,³⁵ it has cought economic growth for all the members of it. Ultimately, greater cooperation would lead to a common market, which would positively affect on the members' economic growth.³⁶ At the same time, countries involved would be more unified, due to closer economic relations. Only later, political and social aspects have been added to the concept,³⁷ but the economic consensus has remained a key aspect of this great Union.

The main goal of the EU and its predecessor was to create a fully functioning common market,³⁸ intially developed into current type of single market.³⁹ Without required coordination of both direct and indirect taxation, these markets would not have been able to flourish. Thereby, it is only possible to make sure that companies in different member states are in equal position and competition is not distorted. Since the beginning of the European Union, taxation policy has been a vital tool to ensure functions of the EU, integrate member states and support other EU policies such as economic, employment, health and consumer protection policies.⁴⁰ The general taxation policy of the European Union allows each Member State choose its own taxation system with full sovereignty.⁴¹ Thus, EU is not setting the tax rates of any the states. However, tax system shall

³⁴ Craig, P., de Búrca, G. (2011). *EU Law Text, Cases and Materials*. 5th ed. Oxford, Oxford University Press, p 266.

³⁵ The Economics of the European Union, (1996), *supra nota* 2, p. 4-32.

³⁶ *Ibid.* p. 32-60.

³⁷ Craig, P., de Búrca, G. (2011), *supra nota* 34, p. 2-19, p. 581-600

³⁸ *Ibid.* p. 2-19, 581-600

³⁹ Wasserfallen, F. (2014). Political and Economic Integration in the EU: The Case of Failed Tax Harmonization. – *Journal of Common Market Studies* vol. 52 p. 423-425

⁴⁰ The European Union (2015). The European Union explained: Taxation - Luxembourg: Publications Office of the European Union. p.3-4

⁴¹ Keuschnigg, C., Loretz, S., Winner, H. (2014). Tax Competition and Tax Coordination in the European Union: A Survey Working Papers in Economics and Finance, University of Salzburg, No. 2014-04. p.2-4.

comply with the requirements, which are set by the Council.⁴² Basically, this means that there are 28 different taxation systems in the European Union, which in fact may differ considerably. All in all, systems are complying with the requirements set by the Council.

Taking the diversity of the taxation system in EU under consideration, it may not be the easiest task to create a single market that does not discriminate against some of the countries, but mainly this has been managed to avoid with cooperation and harmonisation. The EU is ensuring that all the member states are setting rules that are fair and are not giving advantage for companies in any of the states.⁴³ This means, that one member state cannot give companies operating there an advantage over the competitors in other member states e.g. by altering the tax base rate for more reasonable. With the fair and efficient taxation policies, member states are supporting wider EU policy objectives.⁴⁴ As normally, in case there are infringements of the EU law, the Court of Justice of the EU may require the member states to make a change in their respectively law.⁴⁵ Thus, the application of the EU law is guaranteed. There are two ways to refer the case into the Court of Justice. Either the national court or in case of the Commission is suspecting that national law is breaching the EU law it may refer the case to the Court.⁴⁶

As shown, member states are free to determine their taxation. The tax collection is used to finance their own national budgets, to manage their health care, education systems, police operations and pensions. However, it should be noted that EU requires also funds to their budget. This is done by trough EU's own resources, which are directly composed by the contributions from the member states.⁴⁷

2.1 Harmonisation of EU Taxation

Harmonisation of taxation refers to a situation in which the group of countries implements common taxation policies, in order to have a similar tax system.⁴⁸ This can be done, for example, at an international level.

⁴² Remeur., C. (2015). Tax Policy in the EU: Issues and challenges. Brussels: European Parliamentary Research Service. p. 4-7.

⁴³ Schenk, A., Oldman, O. (2007). *Value Added Tax: A Comparative Approach*. Rev. ed. New York: Cambridge University Press. p.64-66

⁴⁴ The European Union (2015), *supra nota* 40, p.3-4.

⁴⁵ Staab, A. (2011). *European Union explained*. 2nd ed. Bloomington, Indiana University Press.p.76-81.

⁴⁶ The European Union (2015), *supra nota* 40, p.5-6

⁴⁷ Keuschnigg, C., Loretz, S., Winner, H. (2014), *supra nota* 41, p.4

⁴⁸ Terra, B. J. M., Wattel, P. J. (2008), *supra nota* 1, p.75-80.

In order to establish most efficient Single Market, there is derived need to harmonise some of the rules considering taxation at the level of EU.⁴⁹ Harmonisation will also help to create a fairer and more unified market both from the point of view of the Member States and the perspectives of the companies established in the different Member States of European Union. Otherwise, when trade barriers within EU were removed, there were some of the countries, which had a relative low tax base rate to lure foreign corporates to invest.⁵⁰ It was necessary to prevent this of flow of capital into these types of countries. Therefore, certain implementations were introduced by EU to combat against distortion of the market powers in cross-border trade.⁵¹ The first invention was the VAT directive, which was adopted when there was not significant amount of cross border trade in 1967.⁵² In the era of digitisation, especially, digital economy is highly affected by the lower tax rates. Companies, running their business on internet, are constantly seeking a place, where they could practise their commercial activity on lower tax rate bases. Considerably, relocation of digitalised is currently rather simple.

In the European Union, the harmonisation work is conducted by the EU's legislative bodies, which able to adopt orders governing the taxation in member states.⁵³ Some harmonising rules are necessary to have a functioning internal market.⁵⁴ In particular, the indirect taxation has been under loop, but the current system is becoming obsolete. This harmonisation work has been, however, widely appreciated and has dismissed taxation competition between different member states. Simultaneously, the harmonisation process of the direct taxation, especially in the area of corporate taxation, is still in progress. This may cause some desirable distortions of the trading powers. Particularly, these negative aspects are highlighted, while comparing e.g. Nordic Countries and some Southern-European countries. Although, the EU has implemented three vital directives, which are Merger Directive, Parent-Subsidiary Directive and Interest-Royalties Directive have been eliminating harmful double taxation and part of the taxation has been harmonised.⁵⁵

It easy to argue that harmonisation has not been that progressive at the international level. There are some agreements between different nations but common policies, which would be extremely important to the entire global economy, are unfortunately missing. There is also lack of jurisdiction in matters of digital taxation. The EU as forerunner has shown examples of legislating rules for

⁴⁹ Terra, B. J. M., Wattel, P. J. (2008), *supra nota* 1, p.75-80.

⁵⁰ Keuschnigg, C., Loretz, S., Winner, H. (2014), *supra nota* 41, p 2-3.

⁵¹ *Ibid.*

⁵² de La Feria, R. (2009). *The EU VAT System and the Internal Market*. 16th ed. Amsterdam: IBFD. p 90-110.

⁵³ Terra, B. J. M., Wattel, P. J. (2008), *supra nota* 1, p.1-3.

⁵⁴ *Ibid.*

⁵⁵ Rohatgi, R. (2005). *Basic International Taxation*. 2nd ed. Vol. 1. Richmond: Richmond Law & Tax Ltd., p.80-83.

digital taxation for the rest of the world. Since digitisation and digital economy are not bordered, but have global implications for each economy, common internationally recognised principles and mechanism concerning taxation of digital transactions would be a beneficial. The EU itself may set rules, but as it stands, these rules are naturally not applicable in the rest of the world. The transactions on internet cannot be controlled like the physical transactions. It will not be an easy task and requires unprecedented international cooperation, but in the end, no one can escape from the effects of the digitisation. In the absence of commonly recognisable taxation policy of digital commerce, one must be organised.

2.2. VAT

The European Union's credit-invoice value added tax is an indirect tax, which can also be described as a general consumption tax due to the tax burden is levied on the purchase of goods or service from the consumer.⁵⁶ In essence, VAT is backbone of the many countries taxation, because it is one of the most profitable sources of revenue for the European Union.⁵⁷ The single market could not be such sufficient as it is now without the VAT system, highly varying value-added taxation in member states would be distorting the competition in a non-wanted way. Therefore, it is unarguably playing a major role, and since it is a consumption tax, VAT system's founding principles, its role will not vanish in the future, rather it will raise together with the consumption.⁵⁸ Second founding principle is the fiscal neutrality, which means that similar products shall be levied on a same way.⁵⁹ This has been reached by harmonising the VAT to be almost identical in whole EU area. For example, products in Belgium are being levied at almost identically rate as products in Bulgaria and the domestic goods and services do not have advantages toward the imported one.

However, it has been admitted that the current system, which is undeniably complex and vast, is obsolete and should be brought into 21st century.⁶⁰ Unfortunately, without prompt acts by the

⁵⁶ Maeser P. P., Halsch, V. (2017). *supra nota* 19, p.5-7.

⁵⁷ James, S., Nobes, C. (1996). *The Economics of Taxation: Principles, Policy and Practice*. 96/97 ed. Hertfordshire: Pentice Hall Europe. p.35-37. EUROSTAT. (2016) Breakdown of tax revenue by country and by detailed tax categories in 2016 (% of total). – [E-Database] [http://ec.europa.eu/eurostat/statisticsexplained/index.php/File:Breakdown_of_tax_revenue_by_country_and_by_detailed_tax_categories_in_2016_\(%25_of_total\).png#filelinks](http://ec.europa.eu/eurostat/statisticsexplained/index.php/File:Breakdown_of_tax_revenue_by_country_and_by_detailed_tax_categories_in_2016_(%25_of_total).png#filelinks) (16 February 2018)

⁵⁸ de La Feria, R. (2009), *supra nota* 52, p 90-110.

⁵⁹ Tyc, V. (2008). Harmonization of indirect taxes in the European Union. - *International Journal of Law and Management*, Vol. 50, No. 2, 87-92

⁶⁰ Keuschnigg, C., Loretz, S., Winner, H. (2014), *supra nota* 40, p.5. Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax. OJ L 347, 11.12.2006

Commission and the Parliament, its full potential as a so-called revenue bringer cannot be fully realized and this valuable income cannot be recovered.

2.2.1 Developments of the European VAT system

The VAT system of the European Union has been developed since the early days of the ECSC.⁶¹ During that time, attempts were made to introduce common turnover taxation by different committees. Its main objectives would have been a more simplified movement of goods and avoid the double taxation.⁶² However, the proposals were rejected. It took many years before for the VAT system to be introduced. It was not until the late 1960s, during the years of EEC, that the VAT directive entered into force. This has followed many new directives and systems, which have been addressed the actual taxation matters. Latest VAT system was introduced in 1993⁶³ after that Directive on the Common system of value added tax has entered into force in 2007.⁶⁴

For time being, EU member states need to harmonise their indirect taxation according to the Sixth Directive, which demands that each member state has to have a standard VAT rate of at least 15 % and the reduced rate of at least 5 %.⁶⁵ In some states certain rates have been set for special products. Like with other forms of taxation, states are responsible for levying these taxes. This operation is usually carried out by the national tax authorities. Without the harmonisation of VAT, the EU would be divided. The VAT bases would have significant differences, which would ultimately affect and distort the competition between companies in different the Member States, with the result that tax neutrality would not correctly applied. The single market could not work sufficient without developments in the field of the VAT. In a globalised world, this insufficiency would be strengthened. As it is directive rather than regulation, there are some differences certainly between Member States, but the main concept is very similar, whether in Spain or in Latvia.

The current VAT system has never been considered as permanent rather a transitional one.⁶⁶ Nevertheless, it is still the system used and the transit period has been quite too long. During the 1990s, most people were not able to foresee the globalisation of the commerce. Lack of preparation

⁶¹ de La Feria, R. (2009), *supra nota* 52, p 90-110.

⁶² *Ibid.*

⁶³ European Commission – Press Release: European Commission proposes far-reaching reform of the EU VAT system. (2017). Accessible http://europa.eu/rapid/press-release_IP-17-3443_en.htm 15 February 2018

⁶⁴ Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax. OJ L 347, 11.12.2006

⁶⁵ Worldwide VAT, GST and Sales Tax Guide 2017. EY 2017

⁶⁶ European Commission – Press Release: Towards a new and definitive VAT system for the EU. (2017). Accessible https://ec.europa.eu/commission/news/towards-new-and-definitive-vat-system-eu-2017-oct-04_en 1 February 2018

concerning the increased mobility of the companies and different treatment of domestic and cross-border transactions are appropriate to demonstrate the weakness of the current system.⁶⁷ Therefore, it is easy to argue that the application of the current system in the European Union, where the cross-border trade has exploded, becomes inefficient. Undeniably, some of the taxes are managed to gather, but big slice is slipping away. In the year 2015, the commission presented its study on the so-called VAT Gap, which is the difference between expected and actual VAT revenues.⁶⁸ The gap counted to be 12,7 %.⁶⁹ There were significant differences between member states in Sweden, counted to be at the top of the table, the gap was -1,4 % and 37,18 % in Romania, which was the worst collector of VAT. It was also acknowledged that the current system opens the door to the possible frauds,⁷⁰ which is likely to explain at least some of the gap.

2.2.2 VAT in the digital economy

The digital economy has quickly gained popularity among the consumers. This can be seen as an increase in sales, as online sales in the EU alone are now worth 550 billion Euros,⁷¹ and the number of different platforms on which these transactions may be concluded, has increased steadily. Unfortunately, due to lack of an efficient VAT system, this revenue cannot be fully collected. There is no doubt that valued added tax has a decisive influence on the services available on the internet. Some issues have already noticed that are excellent examples of the system's fragility. The digital economy is simply stressing the current outdated VAT system, which like noted can be dated back to the 1993 when the boom of the internet has not even started yet.

The current system is ineffective. Certain adjustments have been presented, but the results have been rather cosmetic. Ultimately, this can be seen as a loss of revenue. Some of the estimates assumes that EU and its member states are losing approximately 5 billion tax Euros annually because of the lack of taxation power considering e-commerce.⁷² When the sum is over the half of Estonian state budget,⁷³ addressing of the issue is required. Without prompt acts this number of losses will be increasing while the transactions concluded on the internet are growing. By the year

⁶⁷ Mannio, L. (2001). *Sähköisen kaupankäynnin verotus*. Vantaa: WSOY Lakitieto, p.12-30.

⁶⁸ Center for Social and Economic Research. (2017) Study and Reports on the VAT Gap in the EU-28 Member States: 2017 Final Report. Warsaw. p 9-17.

⁶⁹ European Commission - Fact Sheet Modernising VAT for e-commerce (2017) Accessible: http://europa.eu/rapid/press-release_MEMO-16-3746_en.htm, 22 February 2018.

⁷⁰ *Ibid.*

⁷¹ *Ibid.*

⁷² Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax applied to books, newspapers and periodicals. 1.12.2016

⁷³ Government Approves the State Budget for 2017 (2016). Accessible: <https://www.valitsus.ee/en/news/government-approves-state-budget-2017>, (20. January 2018)

2021, it has been estimated to be around 7 billion Euros.⁷⁴ Finally, in late 2017, European Commission launched the debate on new VAT rules, which would be efficient on cross-border trades, particularly considering matters of e-commerce. It does show that the Commission is willing to tackle this issue, with its all power. Like mentioned earlier, there are rules on electronically supplied services currently. However, some of the conceptual aspects remains open in the absence of categorising and the concentration on essential parts of the services provided digitally. Also, buying directly from abroad is due internet much easier. Levying products, which are imported, requires that the information about the transaction would reach taxation authority.⁷⁵ Many of the foreign companies are not even VAT listed themselves.⁷⁶ Therefore, many of the transactions cannot be levied and the balance between companies' competition is not static.

2.2.3 B2C Transactions: Destination Principle

When considering a domestic transaction, the taxation progress is rather simplified and determining the tax rate will be an easy task. The supplier charges the tax in connection with the sales and deposits it to the tax authority. However, in case of cross-border transaction, there might be slight issues. In the case of a natural person, the VAT rate is determined by the VAT rate of the Member State, where the natural person is currently locating or if the purchaser is resident of the third country applicable rate will be the rate of the destination if there is one.⁷⁷ Namely, this is the destination principle, which the cross-border trade is based on.⁷⁸ So, when services or goods are offered to a natural person, the business providing the service is obliged to find out the customer's location and deposit the VAT to the relevant tax authority. At the moment, this is still one of the greatest challenges related to the digital taxation. There is not a single reliable mechanism to ensure the customer's actual location in a way the EU legislation would demand. Thus, applying the real VAT rate seems to be an utter impossibility. In particular, this may constitute problems for SME's providing small services to the regular consumer, which do not have a capacity for find out the customer location and store the proper data. This worst-case scenario constructs a trade barrier, which is causing the loss of revenue for the companies. There have been suggestions that third

⁷⁴ European Commission - Fact Sheet Modernising VAT for e-commerce (2017)

⁷⁵ Maeser P. P., Halsch, V. (2017). *supra nota* 19, p 8-9.

⁷⁶ *Ibid.*

⁷⁷ Lamensch, M. (2015). *European Valued Added Tax in the Digital Era: Critical Analysis and Proposals for reform*. Amsterdam: IBFD, p.18-20.

⁷⁸ OECD International VAT/GST Guidelines: Guidelines on Neutrality (2011) OECD Accessible: <https://www.oecd.org/tax/consumption/guidelinesneutrality2011.pdf> , 10 February 2018. p.3.

parties could take the responsibilities and verify the customer's location.⁷⁹ To create the system there is need to have a help of the OECD and further international cooperation.

These problems are also creasing the VAT gap since many of the countries are not capable to monitor the transactions. Countries with reasonable high VAT gap should have a stronger and wider tax office to monitor deposits of the VAT. Simultaneously, the VAT frauds related to these transactions are increasing as well. If the countries themselves cannot be in charge of taxing, some of their tax sovereignty could be transferred to the EU or at least, a greater amount of administrative cooperation could be the response on this issue. Later, the developments of generating adequate cooperation, whereas an EU wide mechanism has been seen as a solution, and some proposals of still even wider mechanism will be discussed.

In addition, the destination principle works rather well, when goods are sold in tangible form and they are imported in Europe from third countries. Those will be through customs and VAT may be collected at this point. However, when selling services and intangibles, often on the internet or in another network, and since, the nature of this sort of transaction is that they will never be controlled in customs like tangibles, these are not imposed to VAT.⁸⁰ It remains a question whether these sorts of transactions shall be taxed according to the rules of the jurisdiction of consumption as domestic products. When there is a uncertainty of final destination of service supplied, this may constitute issue considering taxation.

2.2.4 B2B Transactions: Place of Supply Rule and Reverse Charge Mechanism

When considering B2B sales there are also some issues regarding taxation powers. To tackle these issues as well as prevent possible non-taxation and double taxation, the article 44 of the VAT Directive is setting the general rule of the place of supply of services.⁸¹ According to article 44, services supplied to the taxable business the place of supply is the place where the business is located or the permanent establishment if the services are provided to this fixed establishment. If there is not such a permanent establishment or location where the business is running, the place of supply shall be the place where the receiver of the service is locating.⁸² It should be noted that the permanent establishment or the place of economic activity are not necessary if these are not

⁷⁹ Mannio (2001), *supra nota* 67, p. 294-295

⁸⁰ OECD International VAT/GST Guidelines: Guidelines on Neutrality (2011) *supra nota* 78, p. 4-6

⁸¹ Council Directive 2008/8/EC of February 2008 amending Directive 2006/112/EC as regards the place of supply of service. OJ L 44, 20.2.2008, art 44, art 58, art 59 p.12,16

⁸² *Ibid.*

relevant considering the transactions.⁸³ Thus, supplying digital services for the taxable business, the location taxation shall be the buyer's country of residence. Articles 45, 58 and 59 of the VAT directive apply when the business receiving the service is non-taxable. It distributes the taxing power between the Member States and may also be applied in case of a third country and a Member State.⁸⁴ In order to properly apply the general rule of the place of supply of services, the seller must know the location of the buyer and, in some cases, also the current location.⁸⁵

In B2B transaction, the location of the seller and buyer is also determining liability to pay the VAT in the country of taxation.⁸⁶ Usually, in cross-border transactions, the seller is obliged to pay the burden, but in case of e-services, the reverse charge mechanism is applicable.⁸⁷ This means that the seller may sell the product without VAT, but the buyer has now an obligation to inform the local tax authorities about the transaction, so the VAT may be levied. This reduces the burden, which the seller would be facing in case of need to register on the foreign tax authorities. The administrative burden on the seller, which is usually disturbing for small and medium size businesses. Unarguably, registering foreign company to VAT liable in another country may be difficult and constitutes trade barrier, which can be only discovered in transactions concluded between business. Consequently, one trade barrier is removed by reducing the administrative burden and there are some prognoses of preventing the VAT frauds⁸⁸ by implementing the reverse charge mechanism; and thereby flatter the VAT Gap. Finally, all of the businesses are benefitting from the better working environment, which is barrier free.

By updating the old system, many of the companies would have a better environment for the competition, and in particular equal treatment of the European and non-European companies would be desirable. New VAT rules have been claimed to be more satisfactory for the business.⁸⁹ Approximation of the VAT rates and implementation of the destination principle have harmonised the common policy in a positive way, which has had positive impacts on the internal market, but there is still a work to do in order to ensure the status and the location of the consumers and

⁸³ Judgement of 6 October 2011, *Finanzamt Deggendorf v Markus Stoppelkamp*, C-421/10, EU:C:2011:640, paragraph 27.

⁸⁴ Merx, M. (2017). Fixed Establishment in European Value Added Tax: Base Erosion and Profit Shifting's Side Effects? – *ec Tax Review* Vol. 26. (Eds.) B.J. Kiegebld. Alphen aan den Rijn: Kluwer Law. p.36-57.

⁸⁵ Holopainen, J. (2011). Elinkeinonharjoittajien sijoittautuminen arvonlisäverotuksessa neuvoston uuden täytäntöönpanoasetuksen valossa - *Verotus* 4/2011 p.429-437.

⁸⁶ Bellheim, A., et al. (2014) *Your pocket guide to VAT on digital e-commerce*. Stockholm: Bird&Bird Advokat KB p.11-13.

⁸⁷ Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax. OJ L 347, 11.12.2006. p.39. Art. 193, Art. 196.

⁸⁸ Merx, M. (2017), *supra nota* 84, p.36-57.

⁸⁹ European Commission – Fact Sheet Modernising VAT for e-commerce. (2017) *supra nota* 69.

establish observation towards the third country companies. Later Mini One-Stop-Shop (MOSS) will be discussed to show progress concerning the companies of the third countries. Therefore, by updating current tax regime, foreign companies would not be in a prosperous competing position, but in the same line with European ones.

In conclusion, there is need to implement updates on the current VAT system. The current system was meant to be only transitional, and the definitive system shall be entered into force as soon as possible. Fast growing sectors of the digital economy are overemphasising the system. The pressure is being exerted both by the European companies as well as non-Europeans. The reform package has shown some promises of better, but at the end, only the practical experience, which requires that it will be entered into force, will show the real effects. However, when evaluating the implementations of 2015, the credit has to be given. Basically, the transaction between companies are concluded in a way that does not stress the administrative too much, the reverse charge mechanism has managed to move the burden of the taxes for the companies in their own soil, rather than requires foreign companies to registrate themselves on taxation authorities of the other countries. After all, it is better for the public and for the companies to have an efficient and fair tax system, since it will be bringing more and more investment.

2.2.5 MOSS

In order to update the VAT system. The EU has been introducing different concepts and mechanism that would ultimately lead to smoother trans-border transactions by removing some of the administrative burdens. Thus, the EU internal market would be even more efficient, and collection of taxes could be eased. These proposed schemes would not be only applicable on European companies, but also companies locating outside of the EU.

Mini one-stop shop (MOSS) is designated scheme for the companies.⁹⁰ It was introduced in 2015 and since then it has been applicable on electronically supplied services. Definitely, it has shown good promises and will hopefully be prominent in the future as new aspects are added. At the present, the basic idea is to reduce the administrative burdens, which the companies may face while they are required to VAT register themselves, in order to supply service in one certain Member States. “The scheme allows suppliers to avoid registering in each Member State of consumption. In order to ensure the correct taxation of these services, providers will need to

⁹⁰ Remeur., C. (2015), *supra nota* 42, p.16.

determine the status of their customer and the place to which that customer belong.”⁹¹ Companies may determine by themselves in which EU Member States they register.

Besides cutting the administrative burdens the other respective objective was to reduce the VAT gap, which is considerably high especially in the Eastern European countries.⁹² Hence, this may be described to be a sufficient solution for the needs of the Member States, which do have big VAT Gap and should work on them. The MOSS will not automatically decrease the VAT Gap, but it requires more from the national tax authorities and breaking some of the existing customs.

However, the companies are free to decide whether they register in any of the Member States or are more willing to stay outside of this register. Changing the tax administrative policies in the companies may establish more burden than sticking with old system at least on a temporary basis. These non-compliant companies are hard to be trace by the tax authorities and often causing the loss of VAT revenues. Simply, the tax liability cannot be put into effect.

Although the indirect taxation has been harmonised in the EU, there are some differences allowed by the directive.⁹³ There is need to evaluate the cooperation willingness between the different Member States and consider whether the states are eager to trust their tax sharing on a wider basis than they have used to. Ultimately, this would mean the abortion of some of the Member State sovereignty and would lead more and more to the federal state development, which currently is not welcomed by most of the Member States.⁹⁴ However, positive feedback around the MOSS given by the different sources could add the eagerness to work together. Unfortunately, the system is still new, which hampers the true evaluation of this process.

2.3. Applying Reverse Charge Mechanism on B2C Transactions?

Like mentioned, since 2015, the Reverse Charge Mechanism has been applicable on electronically supplied services between two enterprises in the EU. The non-traditional way of levying taxes has received warmly welcome from the companies by cutting the administrative burden; thus, easing the cross-border trade. Simultaneously, has been preventing the VAT frauds and flattening the VAT Gap. However, would the reverse charge mechanism be applicable and useful also on

⁹¹ Remeur., C. (2015), *supra nota* 42, p.16.

⁹² Center for Social and Economic Research (2015), *supra nota* 68, p 9-17.

⁹³ Kristofersson, E. (2016). Comparative studies of national law in the EU harmonized VAT. – *Nordic Tax Journal*, No. 1 p.29-40.

⁹⁴ Tyc (2008), *supra nota* 59, p. 87-92.

business to consumer transactions supplied as electronic service? Since none of the western world countries is using the reverse charge mechanism on B2C transactions, it would be revolutionary and unorthodox, by transferring the tax liability from the companies to the consumers. In addition, the obligation of the companies to ensure the location and the status of the consumer would disappear, since the customer would have to identify himself while purchasing.

Simple execution of the reverse charge mechanism on B2C transactions would require identification concluded by the consumer while purchasing as well as affirming the current location and the status. This would be fineness of the consumer reverse charge mechanism, which would enable the applicability of the real tax rate. The end-customer would be responsible to account the tax to the authorities, which could be concluded during the transactions procedure as an automated phenomenon, means that collection of taxes may be automated due to digitisation. Currently, the affirmation cannot be reliably determined by the companies, they are obliged to find out customer billing address, IP address, bank details, country code of the SIM card used or other relevant information.⁹⁵ These may not be easily available and may cause the non-taxation of the VAT. In a small scale, it will not cause problems, but these sorts of actions may occur repeatedly.

Regarding the carousel VAT frauds, typical accounting completed by the fraudulent companies and the refund by the tax authorities would be dismissed.⁹⁶ These have been considered the most obvious places to execute a fraud. One of the missions of the MOSS was also removing this possibility. However, it cannot fully dismiss the need to pay refunds as well as being not obligated to the companies not effective. In the field of electronically supplied services, removing of the VAT frauds is possible with the consumer reverse charge method.

Digitisation has provided fluent e-commerce transactions and it is cornerstone for many solutions like mentioned MOSS. Therefore, it could provide a significant tool for this mechanism as well. Also, there are currently everyday activities requiring identifying, like banking solutions, and these can be concluded without extensive disadvantages. The affirming of the location could be completed with the consent of the consumer by using location services for example. Hence, the necessary easy to approach technic solutions would be available. While purchasing, consumers shall be demanded to share the data concerning their real location, which would enable the correct tax rate. Possible problems could arise situations where consumers are trying fake their location

⁹⁵ Council Implementing Regulation of 7 October 2013 amending implementing regulation (EU) No 282/2011 as regards the place of supply of services. OJ L 284, 26.10.2013. Article 24.

⁹⁶ Fedeli, S., Forte, F. (2011). EU VAT Frauds. – *European Journal of Law and Economics*, Vol. 31. No. 2. New York: Springer US, p.146-149.

to take an advantage of lower tax rates. However, if the legal responsibilities lie with the consumers, abuses could be eliminated. It would also be more likely that the consumer would have greater interest to share the data than the business finds the real location and to deposit to the correct tax authorities.

Administrative burdens caused for the companies would not increase, rather decrease, since there would not be a necessity to register in other member state or in MOSS when offering electronic services for the regular consumers. Certain information responsibility of the companies must be included, but it will occur together with the regular accounting. Notwithstanding, the harmful trade barrier caused by the administrative burdens would be removed, which is prerequisite for the really working digital single market. Due to simplified execution, this mechanism shall be used in both domestic and foreign transactions. It is required to implemented system correctly.

Like in case of MOSS, readjustment for the mechanism could take a time. By transferring the tax liability, the possibility of facing resist from the public could be probable. However, the advantages following the affirmation of the status and the location of the consumer that are ultimately initiating of removing or at least decreasing VAT gap and VAT frauds would minimise the disadvantages, which the regular consumer could face.

All in all, the reverse charge mechanism would dismiss the issues of identification the consumer and VAT authorities' capability to trace the non-compliant companies which are ultimately causing the VAT gaps and frauds. The non-willingness of the EU member state, like in case of MOSS, would not appear at the same level. Only, after practical use of the system, the real evaluation of the reverse charge mechanism would be possible. Due to, the technical requirements are to be found, the full implementation of the mechanism could benefit both companies by cutting the administrative burden as well as by reducing the legal obligations, and governments by maximising the VAT revenues. Affirming of the customer status and the location are conditions for a functioning digital single market. However, all this must be implemented without undermining the competition status of the European companies and risking the customer's position and purchasing power.

3. EU VAT COMPARED TO OTHER SYTEMS

As noted earlier, the digital economy is not bordered rather it is globally affecting all countries. OECD has called for more international cooperation, which has not been established for the time being. Furthermore, none of the countries may deny the fact that they will face these challenges, thus coordination and cooperation would be valued. Countries all over the world have been addressing these challenges, but all of them has varying approaches. Countries have had a different type of taxation policy or there are differences in legislation which causes this type of varying. For instance, there is possibility to see clear differences in definitions of electronically supplied services. In order to show variation, it is necessary to compare EU to countries, which have shown development on digital taxation such as New Zealand and Japan.

3.1 New Zealand GST overview

New Zealand country far away in the Pacific is well known for its digital developments in recent years. Certainly, it has introduced interesting changes in its taxation policies since 1980. Basis were different compared to EU, in case of New Zealand, there were only blank pages, which they may be fulfilled as they saw it best. This was one of the keys to creating an exceptional scheme. New Zealand's VAT system is called Goods and Services Tax (GST) and it was adopted in 1986.⁹⁷ After that, many of the Pacific countries have been following the New Zealand's way and introduced similar VAT systems, but also e.g. South Africa, and Singapore do have systems closely related.⁹⁸ For time being, New Zealand's GST rate is 15 %, ⁹⁹ which is same as the bottom line of the VAT rate in the European Union, but when compared to Hungary, which does have the highest rate of 27 %, ¹⁰⁰ there is a significant difference to observe. Since the level of exemptions is relative

⁹⁷ Dalsgaard, T. (2001). *The Tax System in New Zealand: An Appraisal and Options for Charge*—*OECD Economics Department Working Papers*. Paris: OECD Publishing p.8.

⁹⁸ Maples, A., Sawyer, A. (2017). *The New Zealand GST and its Global Impact: 30 Years on*. - *New Zealand Journal of Taxation Law and Policy*, vol. 23. Auckland: Brookers. p.12-16.

⁹⁹ *Ibid.* p.11.

¹⁰⁰ *Worldwide VAT, GST and Sales Tax Guide 2017*. EY 2017 p.418.

low, New Zealand has the highest degree of effectiveness of the value-added tax in the OECD.¹⁰¹ Limiting the exemptions and zero rating and by taxing many of the government services New Zealand is departing from the EU model.¹⁰²

The global reach in has been imposed by the GST and shows different approach compared to EU's VAT system.¹⁰³ Basically, New Zealand has tax registered all the residents on their worldwide supplies.¹⁰⁴ Thus, this system differs from the location of the supply by determining the place of supply in terms of the residence of the seller.¹⁰⁵ Mere implementation of this sort of approach on the EU VAT system would be impossibility and the levying very demanding because of geographic differences. On the other hand, in case of export and New Zealand is considered to be the place of supply, those transactions are zero rated in purposes of GST.¹⁰⁶ On these bases, there is no clear information of detailed location or place of supply due to taxing is not relying on where the supply occurs. In non-global reach countries, they have common policies over the place of supply rules, which was discussed earlier in the EU VAT section. Since this sort of significant difference, there are issues, which are apparent when comparing and trying to coordinate the European Union's VAT system together with New Zealand's GST. However, the reserve charge mechanism has been applicable since the year 2005. This required a place of supply rule considering imported services,¹⁰⁷ which is approximating these systems. According to Section 2 of the New Zealand's GST Act, No. 141 "a person who receives imported services is required to self-asses GST on the value of those services".¹⁰⁸ One reason for applying this rule was increased amount of e-commerce and globalised markets, which are affecting New Zealand as well. In addition, non-residents supplying goods or services in New Zealand are levied by GST.

The inevitable need to comply with the rather common international rules required redrafting some of the New Zealand's GST policies. In October 2016, so-called Netflix Tax entered into force.¹⁰⁹ The draft was answering for the growing amount of services provided remotely via vary network channels and was following the example of EU. Taxation bill targets non-resident companies supplying remote services to consumers in New Zealand and 15 % GST will be applicable on

¹⁰¹ Dalsgaard (2001), *supra nota* 97, p 10-11.

¹⁰² Schenk, Oldman (2007), *supra nota* 42, p.58.

¹⁰³ *Ibid.* p.195-197.

¹⁰⁴ *Ibid.*

¹⁰⁵ Bardopoulos (2015), *supra nota* 31, p.200.

¹⁰⁶ Schenk, Oldman (2007), *supra nota* 43, p.195-197.

¹⁰⁷ Bardopoulos (2015), *supra nota* 31, p. 201.

¹⁰⁸ Goods and Service Tax Act 1985 No 141 of 1985 (as amended) section 2

¹⁰⁹ Du Buisson, J., Pawha, D. (2016) *GST on "remote" services*. Accessible:

<https://www2.deloitte.com/nz/en/pages/tax-alerts/articles/gst-on-remote-services.html>, 20 March 2018.

services like e-books, music, videos and software programs.¹¹⁰ This sort of implementation shows steps toward the common VAT policy, which is set by the OECD and is tackling to minimise the tax leakage, which New Zealand as well has suffered. This is directly affecting only on B2C transactions and transactions between business are not included in this regime.

Like the European counterparts also New Zealanders' legislators are struggling to implement an effective solution to ensure that customer's real location is really in New Zealand. Some of the customers may use certain ways to mask their actual location.¹¹¹ According to the current bill, companies are required to supply at least two pieces of information.¹¹² Although, Inland revenue, the tax authority, has provided some tools to find out the location of the customers. This may constitute trade barriers especially for the small and medium sized business, which may not have enough resources to collaborate on these issues regarding the locating of their customers.

3.2 Japanese CT Overview

Japanese respective VAT is known as Consumption Tax (CT) and it became effective in 1989.¹¹³ It has been described as unique, as revolutionary and an administrative nightmare, since it has been updating the EU VAT system.¹¹⁴ The current standard rate is 8 percent,¹¹⁵ which is relatively lower than ones in the EU. The colourfulness of the VAT history is almost comparable with Japan's history itself by showing interesting variations and proposals since the 1950s. It is very similar to EU VAT, but there are significant differences between these two systems. First, the major difference is that Japanese system does not require registered business to issue VAT invoices on taxable sales.¹¹⁶ However, it does not remove that fact that registered consumption taxpayers should not keep documentation, rather "it is important to note that this does not negate the requirement to substantiate a supply."¹¹⁷ In case of the taxpayer is unable to substantiate the supply, consumption tax input credits may be denied.¹¹⁸

¹¹⁰ Schwanke, A., Stanley-Smith, J. (2016). GST to be Enforced on E-Commerce in New Zealand – 26 *International Tax Review*. p.9-10.

¹¹¹ Schwanke, Stanley-Smith (2016), *supra nota* 110, p. 9-10.

¹¹² *Ibid.*

¹¹³ Schenk, Oldman (2007), *supra nota* 43, p.67.

¹¹⁴ Freiman, B. M. (1991). The Japanese Consumption Tax: Value-Added Model or Administrative Nightmare? - *The American University Law Review*, vol. 40, p.1269-1272.

¹¹⁵ Worldwide VAT, GST and Sales Tax Guide 2017. EY 2017

¹¹⁶ Schenk, Oldman (2007), *supra nota* 43, p.41.

¹¹⁷ Bardopoulos (2015), *supra nota* 31, p. 215.

¹¹⁸ Schenk, Oldman (2007), *supra nota* 43, p.67-69.

Registered sellers in Japan are entitled to claim input tax credits even if they have been purchasing goods or services from an unregistered supplier.¹¹⁹ This is due to invoices are not given to the purchaser rather only the supplier is having documents over the purchases and the consumption tax is assumed to be included in to the final purchase price.¹²⁰ Definitely, this sort of practice adds amount administrative work.

Japan has rather big e-commerce markets and it can be considered as one of the world's biggest e-commerce marketplaces. This sort of trend has demanded Japan to develop its e-commerce taxation. Japan has developed agent system for the foreign companies providing remote services in their area are required to register to purposes of tax compliance.¹²¹ Although, it can be said that Japanese rules considering taxation of foreign companies are a bit of lenient than in the EU. Such comprehensive set of rules considering taxation of B2C transactions have not yet been implemented. Japanese rules may establish foreign companies harms while trading with companies due to implementing e.g. European customs and increased administrative work.

3.3 Common principles in the near future

Albeit, digitisation has provided reasonable solutions for the businesses, governments are unable to take full advantage of the digital solutions provided. It is also important to note that governments are widely using digital implementations to conduct their other services. Simple ways to levy, monitor, and track the VAT payments are within arm's reach. However, these solutions have been ignored. When insufficient cooperation between the countries is added, an extensive international foundation for VAT gaps and VAT frauds is being created. Governments are harming themselves and companies are trying to navigate in the world of sophisticated digital taxation. In the end, the final user as a consumer or as regular taxpayer is the most fragile part of the chain and suffers the damages.

Achieving an international consensus on tax administration and application of taxes is fundamental to the introduction of effective taxation systems in all over the world. Every single nation is struggling with the similar issues considering administrative burdens, classifications of the digital services, VAT gap, VAT frauds, as well as determining the status and location of the customer.

¹¹⁹ Schenk, Oldman (2007), supra nota 43, p.67-69.

¹²⁰*Ibid.*

¹²¹ Agrawal, D. R., Fox, W. F. (2017). Taxes in an e-commerce generation. - *International Tax Public Finance*, vol. 24. New York: Springer, p.916.

Countries are one after another implementing their own solutions for digital taxation and companies are not capable to follow these changes in jurisdictions. Determining the tax liability, depending on the jurisdiction, poses challenges for companies, which harms the trade.¹²² In the worst case, this all causes that companies are unable to practise their business in the specific countries. To counter and ease the trade, countries must be willing to use harmonised mechanism and have similar main principles that have been found useful in many European countries or pick the best cuts from New Zealand taxation e.g. limitations of the exemptions and zero-ratings. These are options to simplify the taxation procedure of the digital services considering both domestic and foreign transactions. A more comprehensive application could do a favour for both companies and governments struggling with taxation issues.

For instance, proposing the full implementation of the Destination Principle shall not be undermined. This would require e.g. New Zealand to dismiss some of the basics, which have been occurrent for their GST system. The removal of the so-called global reach should be considered as it may harm the implementation of the principles, which would be sufficient for the common cooperation. Neither Japanese nor New Zealanders have not defined the electronically supplied services in their respective jurisdiction.¹²³ This difference may deem whether the transaction is even taxable or is it non-taxable; and therefore, plays in a big role. Clear clarification would remove the trade barriers and assure smoother international trade. Also, possibility to have not only European wide fiscal neutrality rather universal, at least in the field of electronically supplied services. Considering also the implementation of the regular reverse charge mechanism would ease the B2B transactions by giving universal ruling considering levying these transactions.

Wide-scale common cooperation and enforcement of the same mechanisms would positively influence on taxation by providing fairness and efficiency in the whole globe. Earlier introduced consumer reverse charge mechanism, whereby taxes are levied as automated phenomenon, due to digitisation, from the consumer during the transaction itself could serve as possible for the compared countries as well. Hereby, the companies would no longer be depositing the VAT gains and receiving refunds. By removing these aspects, typical VAT frauds would cease to exist. Frequently concluded online transactions are showing that people are willing to make purchases and having capabilities and willing to do so. Adding the levying process would not harm way of purchasing as it would work together. Thus, global tools for the common closer cooperation are

¹²² VAT/GST Treatment of Cross-Border Services (2017) KMPG. p.6.

¹²³ Bardopoulos (2015), *supra nota* 31, p. 215.

already existing without out a doubt. However, governments are not taking the advantages of the solutions provided by the digital world at the same pace than those companies practising their businesses in the digitalised world.

Simultaneously, companies would have a solid global ground where they are not obliged to dive into details of the consumers' local taxation procedures due to wider consumer reverse charge mechanism. For instance, European companies providing their online services in Asia for regular consumers would not be obliged to register them as taxable in each individual country, rather consumers would be paying the relevant VAT during each transaction. Definitely, some of the administrative burdens for the companies would cease causing positive effects especially for the small and medium sized companies. In addition, companies, would not have to affirm the customer location and status, but there would be clear identificatory, which could be used as an affirmation. All the legal responsibilities considering the customer's location have been falling for the businesses. This has caused an inappropriate burden for the companies. Countries do have vested interest to provide the best environment for companies concluding their activities. Certainly, this would provide a solid ground.

The reverse charge mechanism and common database would crucially be easing the tracking of the intangible transactions, which, as already mentioned, is causing problems. This database would contain information on taxation process and cross-border transactions, like MOSS in use of the whole world. Instantaneously, they would act as a digital custom on electronically supplied services. Currently, tracking the movements of the intangibles is hopeless; hence levying these is difficult. There is no possibility to have a customs check like in the case of tangibles and relying on the possible information gained from the supplier and buyer are the only source of information. With a universal reverse charge and common database, there would be an effective system to oversee the transactions as well as more than one source of information. Without the knowledge, levying services is an utter impossibility. If there are no resources to apply reverse charge mechanism, countries shall at least demand companies to registrate in this database. Hereby, transactions would be under surveillance and not kept unattended, which is the case in many of the transactions.

Improving global cooperation and setting common principles in define tax regime are keys to having a globally effective taxation. Cross-border transactions are everyday actions in the common world. So, why the cross-border interaction between the taxation authorities is still in their infancy? As early as the beginnings of the 2000s, the taxation experts recommended common cooperation

and mechanism.¹²⁴ The technologies are being more developed and more frequently used. However, the levying efficiently is still in underdeveloped in the whole globe. Therefore, the international applicability of the same sort of mechanism included with the global databank of the tax bases could be interesting options to cut the VAT gaps and oversee the transactions in all over the global.¹²⁵ Definitive actions have been missing, so now it could be the time to take real actions.

Countries, also some of the non-members, are used to be following of the examples given by the OECD.¹²⁶ The EU, as forerunner through its actions, has often shown by its acts how to implement these guidelines into jurisprudence and these have been followed by the rest. It has also provided interesting tools like MOSS to tackle issues in its own region. Nonetheless, the EU itself failed to find an accurate and sustainable solution to completely dismiss the main issues considering VAT gap as well as status and location of the consumer due to the borderless elements of the digital commerce. The EU may not govern and oversee all the imports outside of its region. These same issues are relative big also in the rest of the world as well. Acting as a united front would ease the implementation of the common principles as well as lead for more administrative cooperation to tackle and ease the issues. There is derived need to have an organised cooperation lead by the OECD.

As affairs stand, the mere implementation of the same principles that are useful in Europe in Japan or in New Zealand is not an easy task. Demanding countries to rip off basics of their taxation systems may be too hard for everyone trying to establish infinite cooperation. However, the introduction of so-called Netflix tax has already shown that, for instance, New Zealand may bend dramatically their legislation and that countries overall are aware of the challenges. Place of Supply rule, the destination principle, the reverse charge mechanism and solutions provided by the digitisation should form the basis for international taxation of electronically supplied services and enable the administrative cooperation between nations that allows a better digital environment.

¹²⁴ Mannio (2001), *supra nota* 67, p.290-295.

¹²⁵ Mannio (2001), *supra nota* 67, p.290-295.

¹²⁶ OECD International VAT/GST Guidelines: Guidelines on Neutrality (2011) *supra nota* 78.

CONCLUSION

The primary object of this thesis is to give an overview of the digitisation and its effects of taxation in the EU as well as in compared countries and more accurately, determine whether the reverse charge mechanism introduced by the EU on transactions between business would be applicable also on business to consumer transactions supplied as electronic service and secondly, would it help to ensure the status and the location of the consumer supplying electronically services; hence, the correct applicable rate.

On the basis of the of this thesis, it can be concluded that countries are facing similar challenges in their respective jurisdiction. These challenges are related to the classifications of the services provided electronically, relative high administrative burdens and affirming the location of the status of the consumer, which all are affecting negatively on VAT gap. At the same, real tool against VAT frauds has not been found. None of the compared countries is capable to deny the challenges related to the taxation of digital services. Although, the EU's VAT system is currently stressed by the digitisation, EU as forerunner has shown eagerness to solve these issues related to the challenges in question. This example has been followed by the various countries, but the harmonised way is still missing, which is widely varying jurisdictions and as partially causing trade barrier.

Solutions of the European recommendations can be found in the directives, which are the main sources of VAT system used in the EU. Principles of the fiscal neutrality and consumption have been presented. EU's newest tool MOSS is showing progress toward the smoother trade and cutting the administrative costs, which are seemingly causing a headache for the companies as well as for the tax authorities. Simultaneously, MOSS aims to prevent the VAT frauds and decrease the VAT gap in certain Eastern European countries. The thesis has taken a slightly different approach to the matter and demonstrates possibilities to use reverse charge mechanism also on B2C transactions.

Some of the common characteristics are missing, which is harming the cooperative administration work between the countries. Global consensus and harmonised mechanism could prove the

situations. For instance, widespread recognition of the destination principle could serve as a solution for some of the problems concerning tax liability. A good example is the reverse charge mechanism, which was introduced in comparison countries after the EU released its own after the OECD recommendations. It has effectively clarified the taxation of B2B transactions in the world of digitisation. This thesis is suggesting implementing of reverse charge mechanism also to be applicable on B2C transactions on worldwide basis not depending of the thresholds of the transactions. This suggestion is supported by the research conducted. The digitisation has provided a capability to account taxes as automated phenomena during the transactions itself is taking place.

To conclude, the cooperation and international consensus are required to tackle similar issues occurring on digital taxation. With the lead of OECD, there is to establish, commonly recognised principles, clarifications and mechanism, which are key to have an effective taxation system in its member countries. Application of the reverse charge mechanism shall be considered as wider scope at least to cut VAT gap and prevent the VAT frauds.

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