Value Added Taxes in Cross-border E-Commerce: European Approach Towards Electronically Supplied Services

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1 Introduction

1.1 Subject matter

Customers in the European Union (EU) purchasing goods or services are usually can not be surprised with the marks that the price is stated with, or without, “VAT”. Indeed, Value Added Tax (VAT) is a very common and convenient method of levying taxes, and can be seen in almost all business-to-consumer supplies\(^1\). Thus, when buying a new mobile phone or music CD in a local store, customers will almost certainly pay VAT.

Nonetheless, technological progress brought challenges into such certainty. Nowadays new kinds of goods and services have appeared. 'Electronic', 'digital' or 'intangible' is the usual reference to them. Digital goods and services do not require tangible medium to be delivered and can be easily transmitted from a distance through the internet. A song, a film, a software program, or a book, can be bought in a digital format and instantly delivered to a customer. Thus, there is no need to go to a local shop to make a purchase. A seller can be situated in any other country and operate through an online shop. In addition to this great convenience, it also brings significant issues for lawmakers, lawyers and legal academics. For instance, should VAT be levied when a European consumer buys a digital version of a book for his e-book reader, a music album for his portable media player or an application for his smartphone from an online store in the United States (US)? If the answer to the question is affirmative, how shall it be collected and who should do it? Who should receive it, the European tax office or the US tax office?\(^2\) And probably the most complex question: is it feasible to collect VAT on such intangible supplies in the internet?

The EU has developed an approach, which can probably answer the questions above, except for maybe the last one. However, the answers also bring about new

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1 The term ‘supplies’ is used in the meaning of “the act of supplying” and used interchangeable to the term 'transaction'.
2 US does not have VAT. Consumption taxes are represented by “sales and use taxes”.
questions, debates and discussions. The main aim of the thesis is to analyze current the situation in respect to this. That is, what is the EU approach towards the VAT taxation of digital supplies? Is this approach viable and suitable for its purposes? Also, an attempt was made to define biggest flows of the EU approach and examine available solutions that may counteract this flows.

This topic is of great interest for a few reasons. Firstly, the regulation of taxation of digital supplies is in the initial stage in a majority of countries and the EU can be considered as a pioneer in this field. That is why the EU experience is of significant importance for other countries and the international community.

Secondly, one can expect growth in the trade of digital goods and services in future. As technological progress continues, new digital goods and services will appear. If sufficient legislation is not developed now, countries may face significant revenue loss in the future.

Thirdly, international trade has become even more feasible for businesses with the intangible supplies. Technically, cross-border supplies of digital goods do not differ from supplies within a country. It carries great potential and convenience for suppliers, as well as for customers. Thus, the increase of international trade in digital goods and services can be expected.

Fourthly, once again, there has been an attempt to apply conventional laws towards the Internet. The application of the conventional taxation law rules to the Internet can influence its overall regulation. The future of the Internet and the way it will look, as well as the future of trade in digital goods, depends on current decisions. That is why it is so important to choose the right regulation now, as the base for oncoming development.

1.2 Scope and Limitations

This thesis examines the EU requirements for the application of VAT to digital supplies\(^3\) in cross-border trade. Supplies of tangible goods and conventional services, which are ordered by means of the Internet, are not considered here, as well as supplies

\(^3\) The term “digital supplies” is used interchangeable to “electronically supplied services” in this thesis.
of telecommunication and broadcast services, which despite the intangible nature and ability to be transferred via electronic networks as the Internet, are also outside the scope.

This thesis focuses on business-to-consumer (B2C) transactions. The reference to business-to-business (B2B) supplies which can also be found, is mainly made for clarity in understanding. The scope of the thesis encompasses both intra-community\(^4\) and out of community supplies. An international approach towards taxation of digital goods and services is considered as the source of possible options for resolving issues of EU approach and does not represent a primary issue of the examination.

1.3 Structure

Chapter 1 is the introduction.

Chapter 2 introduces basic elements of the subject matter of this thesis. It examines the background notions of electronic commerce, electronically supplied services and basic EU VAT legal documents.

Chapter 3 contains an analysis of the current EU legal documents on the subject matter of this thesis. Furthermore, the explanation of the suppliers' rights and obligations based on EU legal documents is given.

Chapter 4 examines problems and weaknesses of the current approach. Available options that allow the counteraction of weaknesses and flaws are also considered.

In Chapter 5 some practical examples are considered in an attempt to show how some suppliers apply EU requirements in practice.

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\(^4\) Cross-border trade within the EU.
2 Background

2.1 Electronic commerce

The appearance of electronic commerce (e-commerce) would not be possible without a technical platform which is represented by the Internet. The rapid development of the Internet, in its turn, can be linked to the invention of the World Wide Web (WWW) by Tim Berners-Lee. Before that time the Internet was not a “user friendly” network and was operated mainly by engineers from research centres and universities. The invention of the first web-browser and the first web-server in 1990 by Berners-Lee has created the important precondition for the development of WWW. The new internet service significantly simplified the way of using and handling the information in the net. The invention of the graphic web-browser Mosaic in 1993 is considered by some scholars as the beginning of the Internet era.

At the end of 90s a personal computer at a home with the access to the Internet became popular in the Western countries and each additional user was decreasing the price of the connection to the Internet. Convenience, speed and cheapness led to the mass spread of the new technology. Undoubtedly, this was going to lead to the commercial usage of the Internet and sooner or later business was going to start to “make money” on it.

Making money by means of the Internet, doing business on the Internet or doing business electronically is a usual reference to e-commerce. Thus, buying and selling any product by the use of electronic networks, such as the Internet, is e-commerce.

Although, there is no universal definition of e-commerce in EU directives, the EU approach can be demonstrated by the Commission's Communication on “A European

5 Poole (2005), p.15.
6 Poole (2005), p.16.
7 Poole (2005), p.3.
8 “maybe they could get millions of people [...] and make money” this were the thoughts of Andy Bechtolsheim, co-founder of Sun Microsystems, before signing the 100000$ check, as the first investment into Google. Gilbert (2009), p.10.

The notion of e-commerce encompasses both kinds of the trade, “direct electronic commerce” and “indirect electronic commerce”. The former refers to pure digital trade, when all stages of the trade (e.g. order, payment and delivery) are conducted digitally through the Internet. The latter represents just electronic ordering of tangible goods or services, for instance, ordering of a tangible book using on-line shop.

In this thesis only direct e-commerce is discussed, that is, when goods and services are delivered solely by means of electronic networks.

2.2 EU legal documents on VAT in e-commerce

It is believed that the idea of VAT was proposed by German businessmen Carl Freidrich von Siemens in the 1920th and by T.S. Adams in 1921 in the United States. Thirty years had passed before the idea was implemented in practice. It was France who instituted VAT on the national level in 1948 for the first time. Though, that was a simplified version, which was subsequently improved, it had initiated the spread of VAT around the world.

In 1967 the ECC made it obligatory for future and existed members to implement VAT on national level. That was the requirement of First VAT Directive which was adopted simultaneously with Second VAT Directive. The former directive consisted

9 COM(97) 157 final.
10 COM(97) 157 final, p.2.
11 COM(97) 157 final, p.2.
12 COM(97) 157 final, p.2.
14 The European Economic Community was the predecessor of the EU.
only of six articles, moreover, only two of them were decisive. The first article obliged
the member states to change their turnover tax systems into VAT-based systems, while
the second article provided the definition of VAT. Second VAT Directive complemented
First VAT Directive and prescribed more detailed rules concerning the implementation
of the VAT system.

Adoption of Third VAT Directive\textsuperscript{17}, Forth VAT Directive\textsuperscript{18} and Fifth VAT
Directive\textsuperscript{19} was necessarily to extend the deadline of the implementation of First VAT
Directive, because some countries were unable to implement it within the specified
time.\textsuperscript{20}

Subsequent Sixth VAT Directive\textsuperscript{21} was adopted in 1977 and significantly changed
the VAT regulation. It repealed Second VAT Directive and setted up new principles.
That Directive had been in force for 39 years and only recently, in 2006, was repealed
by current Recast VAT Directive.\textsuperscript{22} Sixth VAT Directive was replaced because it had
become too tangled and complicated as a result of the amends and recasts. To clarify
and rationalize\textsuperscript{23} the structure and the wording of the legislation new Recast VAT
Directive was adopted. It brought no new principles or changes\textsuperscript{24} into the regulation,
thus all rules remained unchanged.\textsuperscript{25}

Previously mentioned Directives represent the backbone of the VAT system, which
could be amended by “supplementary” directives, regulations and communications. For
instance, the regulation of e-commerce initially was not covered by any of the
previously mentioned the first six directives. It developed from “supplementary”
sector-specific Directive 2002/38/EC which was the starting point in the regulation of e-
commerce and which had to be read in conjunction with Sixth and First VAT Directives

\textsuperscript{20} Terra (2008), p.124.
States concerning turnover taxes Structure and procedures for application of
the common system of value added tax.
\textsuperscript{23} Recast VAT Directive, Recital 1.
\textsuperscript{24} Recast VAT Directive, Recital 3.
\textsuperscript{25} Correlation table between new articles and articles from previous Directives can be found in Annex II
of the Recast VAT Directive.
In the early days of the Internet the e-commerce did not constitute a significant part of the economy, so it was governed by general VAT rules. With the development of technologies and the growth of the trade the legislator had to adopt specific rules for governing ESS, because general VAT rules were too vague in respect of digital supplies.

As it was already mentioned, the Directive 2002/38/EC initiated ad hoc regulation of ESS. This Directive for the first time laid down specific rules for the regulation of e-commerce. The subsequent Regulation 1775/2005 did not change the principles of the regulation, but defined e-services more precisely. The goal of Recast VAT Directive was to encompass diverse documents in its unified version.

Current regulation of ESS, as it can be seen in Illustration 1, is mainly governed by three EU legal documents. They are: a) Recast VAT Directive, which constitutes basic VAT requirements for all goods and services, including ESS; b) Directive 2008/08/EC, which, among other things, brings important changes starting from 2015;\textsuperscript{26} c) Regulation 282/2011, which, inter alia, clarifies such notions as ESS, place of residence, status of the customer etc.

2.3 Origin and destination principles in taxation

As references to taxation at the place of origin or destination are constantly used in this thesis, these notions should be defined.

Generally speaking, the place of taxation is defined by a place of supply\textsuperscript{27} and

\textsuperscript{26} This issue is discussed further in Chapters 3.3.2 and 3.3.3.
\textsuperscript{27} Case C-166/05, Provisions 8 and 27.
usually these two terms are used interchangeably. A country can tax a transaction only if this transaction is deemed to take place in the country.

Legal theory distinguishes “origin” and “destination” principles of indirect taxation in cross-border trade. Under the origin principle taxes are collected in the country where goods or services were produced. No taxes are imposed in the country of destination under the pure origin principle. The benefits of such theory include the administrative simplicity for suppliers. Businesses have to know only local law and the local tax authority, because there is no duty to levy taxes in the destination country. Nonetheless, such approach can distorts international trade. Countries can levy different export tax rates on identical goods and it will lead to unequal prices in the country of destination. Moreover, some goods and services can be subject to taxes in one country and exempt from the tax obligation in another. It is evident that suppliers would wish to move to countries with lower tax rates. It, in turn, can lead to the “race to the bottom”, when countries permanently decrease their tax rates in attempt to attract businesses.

The destination principle supposed that goods and services are taxed in the country of consumption, usually it is the place where goods and services are delivered. Under the pure destination principle, goods and services are not taxed in the place where they were produced and thus leave their origin country without being taxed. Supplies arrive to the country of destination free from taxes and only then the taxes normally applied to identical goods irrespectively of the country of origin. Such approach do not distort cross-border trade. Nonetheless, countries have to be able to control incoming supplies in order to impose its taxes, therefore more strict monitoring is required on the borders. The destination principle is more common in international trade than the principle of the country of origin. Besides, the destination principle is supported by such international bodies as the EU, the World Trade Organization (WTO), the Organisation for Economic Co-operation and Development (OECD) and most of the major

31 “In a world of perfect competition, the destination principle implies that all firms receive the same tax-exclusive price from selling in any location irrespective of their country of residence”, Ligthart (2004), p.3.
32 Ligthart (2004), p.3.
33 OECD is an international economic organization which consist of 34 members (as of November
countries rely on it.\textsuperscript{34}

\footnotesize{2011) of high developed countries. Despite the fact that the organization's guidelines and reports are non-binding documents, they are usually transferred into members state legislation or binding treaties.  

\textsuperscript{34} Schenk (2007), p.183.}
3 Basic Concepts

3.1 Electronically supplied services

The EU has special VAT regulation of direct e-commerce, and thus it is important to precisely define digital goods and services with respect to which the law is applied. Otherwise the EU member states can, basing on difference in definitions, apply different law to the same digital supplies.

The EU legislator has created separate sub-group of Electronically Supplied Services (ESS) for all digital goods and services that fall under the special regulation. The EU defined ESS\(^{35}\) in its Regulation 2011/282 as:

‘Electronically supplied services’ [...] shall include services which are [1]delivered over the Internet or an electronic network and [2]the nature of which renders their supply essentially automated and [3]involving minimal human intervention, and [4]impossible to ensure in the absence of information technology.\(^{36}\)

Nonetheless, when electronic networks are used solely for the purpose of communication, it does not itself mean that supplied service is ESS. For instance, when supplier and customer use e-mail for the purpose of communication, it itself does not mean that a supplied service becomes ESS.

The indicative list of ESS consists of the following services:\(^{37}\)

1. Website supply, web-hosting, distance maintenance of programmes and equipment;
2. supply of software and updating thereof;
3. supply of images, text and information and making available of databases;
4. supply of music, films and games, including games of chance and gambling games, and of political, cultural, artistic, sporting, scientific

\(^{35}\) In this thesis the notions of ESS and digital supplies are used interchangeably.

\(^{36}\) Regulation (EC) 2011/282, art.7.

and entertainment broadcasts and events;

(5) supply of distance teaching.

ESS also does not include telecommunication, radio and television services, as well as digital goods on tangible media, such as CD with software or DVD with films.\(^{38}\)

### 3.2 Taxable and non-taxable persons

One of the definitions of “taxable person” says that it is a person who is obliged to register for VAT.\(^{39}\) Recast VAT directive defines a taxable person as: “any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity”.\(^{40}\)

“Taxable person” is not necessarily the person who bears burden of taxation. It is rather someone who carries out an economic activity and acts as a tax intermediary or a tax-collector, who later transfers taxes to a tax authority. The notion of “taxable person” should not be confused with the notion of “taxpayer”.\(^{41}\) A taxpayer bears the burden of taxation and his income suffers from taxation. In the majority of B2C transactions a consumer is the taxpayer and a supplier is the taxable person.

The notion of “Non-taxable person” is opposite to the notion of “taxable person”. Roughly speaking it is a person who is not required to be registered for VAT.

In this thesis the expression “supply to business customer” is used in preference to “supply to a taxable person”, “supply to private customer” - in preference to “supply to a non-taxable person”.

### 3.3 Place of taxation

#### 3.3.1 Place of taxation before 2003

According to Second VAT Directive (which together with First VAT Directive established VAT in the EU) goods were taxed in the country of destination\(^{42}\) while

\(^{38}\) More detailed list of goods and services, which can be confused with ESS, see in Regulation (EC) 2011/282, art.7.


\(^{40}\) Recast VAT Directive, art.9(1).


\(^{42}\) Second VAT Directive, art.2(b), art.9(3); exemption from art.5(4)(a) by art.10(a).
services at the place of use and enjoyment.\textsuperscript{43} Thus, the destination principle was the main rule for any supply. At that time there were no distinction between supplies from the EU Member States and non-Member States, which means that there were no special regulation for the intra-Community trade.

With the adoption of Sixth VAT Directive the destination principle was replaced by the origin principle. At the time when electronic supplies appeared they began to be treated as services, not goods.\textsuperscript{44} The main rule for determining the place of taxation for services in Sixth VAT Directive was stated in Article 9(1):

\begin{quote}
The place where a service is supplied shall be deemed to be the place where the supplier has established his business or has a fixed establishment.\end{quote}

It meant that transactions from non-EU suppliers were free from VAT (both B2B and B2C). At the same time transactions from EU suppliers were burdened with VAT regardless of the destination of transactions and status of customers. Thus, for EU customers it was advantageous to purchase from non-EU suppliers, because their price was without VAT and, all other things being equal, cheaper than the price from EU suppliers. On the other hand EU businesses were in a disadvantage not only on the EU market, but also on an international level, because they had to levy VAT on all their supplies and, certainly, it led to reasonable complains from EU businesses.

Thus, one can say that before the adoption of sector-specific rules for ESS the majority of e-commerce services were covered by the main rule of Article 9(1), that is, they were taxed at the place of origin (see Table 1).

\textsuperscript{43} Second VAT Directive, art 6(3).
\textsuperscript{44} In its communication COM(1998) 374 final the Commission concludes that: “All types of electronic transmissions and all intangible products delivered by such means are deemed, for the purposes of EU VAT, to be services”. In addition, the Commission agreed that the same product can be treated differently depending on a form of delivery: “Products that, in their tangible form are treated for VAT purposes as goods are treated as services when they are delivered by electronic means”(ibid). This approach was supported by the subsequent directives. Digital products are still treated differently depending on the method of delivery. On a tangible media they are goods, while an during electronic delivery they are services.
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<tr>
<th>Supplier</th>
<th>Customer</th>
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<td>B (non-EU)</td>
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<td>C (EU)</td>
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<td></td>
<td>C (non-EU)</td>
<td>Origin</td>
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*Table 1: The place of taxation for ESS before 2003*

### 3.3.2 Place of taxation within 2003-2015

The problems of taxation stated in the previous sub-chapter were acknowledged by the EU Commission in its communication in 1998: 46 “where supplies from non-EU countries are concerned [...] with few exceptions, services received by EU private persons are not, under existing provisions, subject to VAT (the volumes of such supplies is at present very small)”. Probably because of the insignificant volume of ESS at that date, the EU introduced new rules for ESS only in 2002, with the adoption of Directive 2002/38/EC, which entered into force in 2003.

The task of Directive 2002/38/EC, which amended Sixth VAT Directive, was to level the playing field by introducing ESS and moving them out from the general rules with the origin principle. As Sixth VAT Directive was repealed by Recast VAT Directive the analysis of current rules will be based on the latter Directive.

The general rules for services in Recast VAT Directive are defined by Articles 44 and 45 (see Annex I). The special rules for ESS are defined in Articles 58 and 59 (see Annex I), and they govern only supplies: a) from non-EU suppliers to EU private customers; b) from EU suppliers to non-EU private customers. Thus, all other kinds of ESS are governed by the general rules.

According to Article 44, the place of supply to a business customer should be the place where business customer is established. Firstly, it means that EU suppliers do not need to levy VAT on transactions to non-EU business customers and business customers

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46 COM(98) 374 final.
47 Currently in force, as of November 2011. See also Chapter 2.2.
in other EU member states. For instance, German suppliers do not need to levy VAT on transactions to US and UK (United Kingdom) business customers. Secondly, it means that VAT have to be remitted to the country of business customers. For instance, VAT on transactions from US or UK suppliers to German business customers have to be received by Germany\textsuperscript{48} and German VAT rate should apply.\textsuperscript{49}

Article 45 stipulates that, as the general rule for services, the place of supply to private customers should be the place where supplier established. Nonetheless, this rule applies only to transactions from EU suppliers to EU private customers and in force until 1\textsuperscript{st} January 2015\textsuperscript{50}. Thus, EU suppliers selling to EU private customers have to levy VAT at the rate that is accepted in the supplier’s member state. For instance, transactions from UK suppliers to German and French private customers have to be taxed by the UK and therefore the UK VAT rate should apply.

Article 58 applies only to ESS and defines the place of taxation for transactions from non-EU suppliers to EU private customers as the place where the private customer has his permanent address or usually resides. Therefore VAT rates that are adopted at EU private customers’ countries should apply. For instance, transactions from US suppliers to UK and German private customers should be taxed by the UK and Germany respectively. Thus, UK and German VAT rates should apply respectively to UK and German transactions.

Article 59 also applies only to ESS and states that the place of supply for non-EU private customers is the place where he has his permanent address or usually resides. It means that EU suppliers do not need to levy VAT on transactions to non-EU private customers. For instance, a UK suppliers do not need levy VAT on transactions to a US private customers.

Thus, starting with 1\textsuperscript{st} of July 2003 and before 1\textsuperscript{st} January 2015 all except one kind of transactions (see Table 2) received the destination principle.

\textsuperscript{48} Business customers have to self-assess VAT by use of reverse charge mechanism.
\textsuperscript{49} EU member states can have different VAT rates, starting with 15% and up to 25% (standard rate as of November 2011, there is also reduced rates for special categories of products, which do not applies to ESS). Luxemburg has the lowest possible standard VAT rate 15%.
\textsuperscript{50} See Chapter 3.3.3.
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<th>Supplier</th>
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<td>C(EU)</td>
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<td>C(non-EU)</td>
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<td>Destination</td>
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*Table 2: The place of taxation for ESS between 2003-2015*

Remained the origin principle for intra-EU B2C supplies involved the following criticism $^{53}$:

- There is an incentive for suppliers to establish themselves in an EU member state with a low VAT rate;
- EU suppliers established in an member state with a high VAT rate are in the competitive disadvantage with those who are established in a member state with a low VAT rate.
- Non-EU suppliers have greater compliance burdens than EU counterparts.

There is an opinion expressed in some sources, $^{54}$ that the legislator left the origin principle for intra-EU B2C supplies at the request of Luxemburg. The jurisdiction of Luxemburg was popular among e-business due to a low VAT rate and if EU Council had substituted the origin principle, those business would have lost an anticipated low VAT rate.

### 3.3.3 Place of taxation after 2015

Taking into consideration complains and trying to achieve full harmonization in ESS supplies, the EU adopted special provisions concerning ESS in Directive 2008/8/EC. Article 5 of the Directive, $^{55}$ inter alia, stipulates that on the 1$^{st}$ of January 2015 Article 58 of the Recast VAT Directive has to be substituted. According to the

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51 Articles of Recast VAT Directive.
52 In force only till 1 January 2015. See Chapter 3.3.3.
54 Merz (2010).
55 See Annex I.
future Article 58, the place of supply for ESS transactions from any supplier to an EU and non-EU private customer has to be the place where a private customer has his permanent address or where he usually resides. Thus, future Article 58, in addition to non-EU suppliers, applies also to EU suppliers. Starting with 2015 transactions from EU suppliers to EU private customers have to be taxed at the country of destination. For instance, in transactions from UK suppliers to German private customers German VAT rate should apply. In transactions from UK suppliers to French private customers VAT should be paid in France according to effective French VAT rates.

As the result, starting from the 1\textsuperscript{st} of January 2015 the destination principle will be applicable to all supplies of ESS (see Table 3).

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Table 3: The place of taxation for ESS after 2015

Therefore, both EU and non-EU suppliers will be in the same conditions starting with the year 2015. One can expect that both of them have to be satisfied with such state of things, however, the implication of such approach in practice is connected with many difficulties, and complains from both sides could be heard.\footnote{More detailed discussed in Chapter 4.}

### 3.4 VAT intermediaries

The destination principle designates the country, where the taxes should be paid, however, it does not define who is obliged to collect and remit VAT to a tax office. In other words it is not clear who is a tax intermediary in a transaction. The legislator had to appoint the tax intermediary i.e. legal or natural person which will have to remit VAT to tax office. There were two options available for legislator, which are usually met in
practice:\textsuperscript{57}

- The most common solution is to impose the burden on suppliers.
- The next option is to impose the obligation to remit VAT on consumers.

It was evidential that for B2B transactions to EU business customers it is better to impose the obligation on EU business customers rather than on suppliers. They are reside at the same country with the tax office to which they are accountable and, therefore, they can be easy controlled.

However, the biggest complexities appear in B2C transactions to EU private customers. The first option available here is to impose the obligation to collect taxes on private consumers, as it is made, for instance, in the US where consumption taxes partly are levied by means of “use tax”\textsuperscript{58}. Private customers that have bought goods outside of the home-state have to declare and pay use taxes, if their state levies this kind of taxes. The same could be made by EU private consumers for ESS supplies. For instance, a UK private customer that bought and downloaded music album from a US supplier has to calculate due VAT by himself and then transfers it directly to the UK tax office.

The second option is to impose the obligation on suppliers, who in this case are situated in another country and accountable to another tax office and almost unreachable for law enforcement.

Nonetheless, the EU legislator has decided that in B2C transactions suppliers have to deliver VAT to the tax office. Thus, it is non-EU suppliers who has to assess, collect and remit taxes to the appropriate foreign tax office. For instance, US suppliers in transactions with participation of UK private customers have to collect VAT according to the effective UK VAT rate and then deliver it to the UK tax office. As before 2015 intra-EU B2C transactions are governed by the origin principle, this rule does not apply to EU suppliers. Nonetheless, starting with 2015 EU suppliers selling to private customers from another EU member state will have to collect VAT under the rate that is adopted in the customer’s country and subsequently remit it to the customer's tax office. For instance UK suppliers selling to private customers in France will have to apply the

\textsuperscript{57} Other possible options in addition to this two are discussed in Chapter 4.4.2.
\textsuperscript{58} For more more information sales and use taxes, see Ward (2006).
3.5 VAT remittance

Under the existing legislation the destination principle covers almost all ESS transactions and starting from the year 2015 it will cover all of them. As it was stated in the previous sub-Chapter, taxation at the place of destination presupposes that previously collected VAT should be remitted to the tax authority at the consumer’s country.

It is not a big issue when the person responsible for VAT remittance is established in the country where the taxes should be returned. For instance, in B2B cross-border transactions EU business customers, which are established in the same country with its tax authority, have to self-assess VAT. The question of the practical realization arise in B2C transactions where a supplier is from another EU country or from a non-EU country. How can a supplier collect and remit taxes on supplies to a foreign state without having any establishment or presence there? There are three available options, which are discussed below.

3.5.1 Options available besides the Special Scheme

a) The most evidential solution for non-EU suppliers of ESS is to establish themselves at some EU country and thus to be in the same position as EU suppliers.\(^{59}\) EU suppliers have the exemption from taxation at the place of destination until the 1\(^{st}\) of January 2015. So they can levy VAT with the rate that is adopted in their country on supplies to any EU country and submit collected VAT to the local tax office.

b) Another possibility is to register for VAT as non-established supplier at every EU country of anticipated supplies.\(^{60}\) Although the registration for VAT is less onerous than to make an establishment, it should be made in every EU member state of anticipated supplies. Thus, if a supplier wants to cover the whole EU he has to register in each EU member state.

Obviously, these two options were too burdensome for small businesses and for

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60 COM(2006) 210 final, p.13. So called “Normal Scheme” because it available for any supplier, but not only for suppliers of ESS.
businesses that make occasional supplies to private EU customers. Thus, the EU legislator, while shifting from the origin to the destination principle in 2003,\(^\text{61}\) proposed third alternative\(^\text{62}\) for non-EU suppliers of e-services. This option is described below.

### 3.5.2 Special Scheme

The Special Scheme, sometimes referred to as “One Stop Shop Scheme”, were introduced by Directive 2002/38/EC\(^\text{63}\) and later was moved to Chapter 6 of Recast VAT Directive (see Annex I). It allows a non-EU supplier to transfer all collected taxes only to one Member State, the state of identification,\(^\text{64}\) without onerous actions that are required under the general rules. The state of identification, in its turn, will returns taxes to the appropriate Member State (the state of consumption).\(^\text{65}\) The Special Scheme is available only for non-EU businesses who supply ESS for EU private customers.\(^\text{66}\)

Probably the most prominent characteristic of the Special Scheme is that suppliers can register\(^\text{67}\) and submit all necessary reports solely by using electronic means.\(^\text{68}\) Thus, the whole process can be made online without the necessity to leave the home-country.

According to Article 357 of Recast VAT Directive the Special Scheme is in force only until 31 December 2014. Before the same deadline EU suppliers can enjoy their exception from the destination principle.

What should non-EU and EU suppliers of B2C transactions do after 1\(^\text{st}\) January 2015, when the former will lose the privileges under the Special Scheme and latter will have to shift to the destination principle?

Directive 2008/8/EC has solved this issue. The Special scheme will become as the

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61 Directive 2002/38/EC.
63 “Special Scheme for non-established taxable persons supplying electronic services to non-taxable persons” Directive 2002/38/EC art.1 and Sixth VAT Directive art.26(c).
64 Recast VAT Directive, art.358(3). Member State of identification’ means EU member state which non-EU supplier chooses for registration. Supplier has to be registered only in one member state (member state of identification) and then remit to this member state VAT collected from supply to any EU member state. Supplier is also accountable only before member state of identification despite the fact that transaction can be to any member state.
68 Recast VAT Directive, art.362 and 364.
permanent option for non-EU suppliers starting with 1st January 2015. EU suppliers, who operate under the destination principle for intra-EU B2C transactions in 2015, will have the same options that non-EU suppliers have now, particularly: a) to establish themselves in the EU member state of the anticipated transactions; b) to register for VAT as a non-established supplier in the EU member state of the anticipated transactions; c) the additional option, so called “Mini One Stop Shop Scheme”, will be available for EU suppliers as of 1st January 2015.

The key elements of the Special Scheme for EU suppliers are the same as they are in the Special Scheme for non-EU suppliers. All necessary registrations, reports and payments will be possible to make from a distance by the use of electronic means. An EU supplier will have to register himself only in one EU member state, member state of identification, and transfer to designated Member State the amount of VAT collected from all transactions of ESS to other Member States.

This thesis is examine the Special Scheme currently available for non-EU suppliers (One Stop Shop Scheme). Nonetheless, both “One Stop Scheme” for non-EU suppliers and “Mini One Stop Shop Scheme” for EU suppliers, which will be available from 2015, are similar and have similar weaknesses. Therefore, the discussion is applicable to the “Mini One Stop Shop Scheme” as well.

3.5.3 Registration threshold for suppliers of ESS

Another issue that should be examined is an existence or absence of a derogation from the above mentioned rules that would release non-EU suppliers from VAT obligations. For instance, information can be found stating that it is not necessarily for suppliers to levy VAT if their sales to a EU member state are below the special threshold. The clarification should be made in this regard.

The EU has few VAT exemptions on importation, which can be incorrectly extended to ESS supplies.

a) Import of negligible value. This exemption for business suppliers states that:

70 Directive 2008/8/EC, art.5(15) (see Annex I), which add section 3 to the Chapter 6 of Recast VAT Directive.
“Goods of a total value not exceeding 10 EUR shall be exempt on admission. The Member States may grant exemption for imported goods of a total value of more than EUR 10, but not exceeding EUR 22”.  

As it is clear from the wording, this exemption applies only to goods (physical goods) and is not extend to ESS.

b) Distance selling. The rule states that if the amount of distance sales to an EU member state within one year does not exceed 100.000 EUR or 35.000 EUR (EU member states may choose) the place of taxation should be deemed where a seller belongs. However, the exemption applies only to goods (not ESS) and only to intra-Community suppliers. Thus, supplies of ESS can not enjoy this exemption.

Summary

Although, the idea to exempt ESS, with the accumulative sales to a Member State less than 100.000 EUR, originally was in the draft version of Directive 2002/38/EC, it was excluded from the final version. As the result, there are no exemptions for suppliers of ESS and VAT obligations arouse even from a single transaction with a low value.

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73 Recast VAT Directive, art.34.
74 Recast VAT Directive, art.32 second paragraph.
4 Weaknesses and Counteractions

As it was explained in Chapter 2, the EU has different approaches to taxation of B2C and B2B cross-border supplies. The latter relies on self-assessment or reverse charge mechanism when business customers have to assess, collect and remit VAT by themselves. This approach does not differ from the one that covers conventional supplies of goods and mainly does not attract a lot of critics. In contrast, the burden of tax collection in B2C supplies is shifted from private customers to suppliers. This type of transactions represents the most problematic area of e-commerce. Therefore, B2C transactions are discussed in this Chapter, which aims to cover the biggest problems of direct e-commerce and propose possible solutions that can counteract them.

4.1 Realization of the Special Scheme

4.1.1 Weaknesses

Distance communication is considered as the fast and convenient mean of communication and as the main advantage of the EU Special Scheme. Nevertheless, even these advantages can be nullified in case of the weak realization. Overseas businesses usually are not familiar neither with government agencies nor with procedural law of the country of identification. Despite this, a common resource with information regarding obligations in e-commerce is absent on the EU level. The awareness of suppliers suffers, which eventually can lead to non-compliance. In addition, state agencies' red-tape and delays in communication can significantly restrict or even discourage businesses from the use of the Special Scheme.

For now, it is very hard for businesses to find and examine even basic regulatory requirements, despite the fact that such information is vital not only for foreign suppliers but also for EU businesses. 7 out of 27 web-links, on the EU website which

77 As it was acknowledge by OECD. “Most problematic area of e-commerce – business-to-consumer (B2C) transactions which can be entirely digitally fulfilled and do not involve physical shipments”, OECD TAG Report (2000a), p.15.
suppose to lead to member states' tax administrations\(^78\) do not function. When it is crucial for businesses to receive fast and accurate information, tax administrations might not answer on an inquiry made through the e-mails,\(^79\) whereas such mean of communication sometimes is the only possible for foreign suppliers. While the obligation on suppliers to remit taxes is imposed at the EU level, the obligation to provide clear rules and appropriate realization is absent and it leaves suppliers in hope that member states will provide such mechanism themselves.

4.1.2 Possible improvements and solutions

Convenience, efficiency and easiness of the Special Scheme can be improved. For instance, a common website with all information, conditions regarding participation and other details can be created. As for today, tax authorities of member states have separate websites for registrants of the Special Scheme and it can be hard to find the appropriate webpage for registration, not to mention the specific information. A common for all member states resource can facilitate the compliance with obligations.

4.2 Distinction between private and business customers

4.2.1 Weaknesses

As suppliers have to levy VAT only on B2C transactions and not on B2B, the necessity to differentiate business from private customers appears. According to the EU law, a business customer should provide the VAT identification number to confirm that he is the taxable person within the EU.\(^80\) Then supplier has to check the validity of the given number at the special web-page “VIES VAT number validation”.\(^81\) If the number is valid then the supplier may consider the customer as the EU established taxable person and does not levy VAT. Such verification is obligatory for both EU and non-EU suppliers.


\(^{79}\) Only UK tax authority (HM Revenue & Customs) replied on inquiries for information concerning the Special Scheme, which were made at the time of writing of this thesis. The inquire also were made to Belgian, Ireland and Luxemburg, Maltese agencies and no reply was received.

\(^{80}\) Regulation (EC) 282/2011, art.18(a).

\(^{81}\) VIES is a EU VAT Information Exchange System, which was specifically created for the purpose of VAT validation and could be accessed at [http://ec.europa.eu/taxation_customs/vies/](http://ec.europa.eu/taxation_customs/vies/)[Visited November 2011].
Nevertheless, the probability exists that a private customer can provide someone's VAT number together with other information, such as the company name and the registration address\textsuperscript{82} to pretend to be the business registered person. In this case, even having checked this information at VEIS, a supplier can assume that his customer is the EU established business person and will not levy VAT. As the result, the opportunity for private customers to bypass the VAT burden exists.

4.2.2 Possible solutions and improvements

Firstly, it should be noted that the necessity to distinguish private customers from business customers exist also in conventional transactions. Secondly, some part of ESS transactions do not have this problem because of the stated below reasons. From one side, a lot of digital goods and services of B2B transactions can not be used by private customers, such as a complicated software ad hoc created for the business purpose with the appropriate price. Moreover, B2B transactions are usually supplied under a contract or at least preceded by negotiations, where suppliers have an opportunity to find out the nature of a client. From another side, a lot of B2C goods and services are not used by businesses. For instance, purchases of games, music, films or other entertainment products by business customers are very unlikely. Therefore, suppliers usually do not need to differentiate business and private customers in this type of transactions.

For the remained part of transactions, which can be used by both business and private customers, digital certificates\textsuperscript{83} can be used\textsuperscript{84} to tackle the problem. It can be a reliable method to verify that a supplier is really VAT registered. Despite its effectiveness, an implementation of digital certificates in the practice requires time, resource and cost expenditures. The decisive factor here is the estimated value of the fraud in comparison with the implementation costs.

\textsuperscript{82} For instance, it can be his employer's information.
\textsuperscript{83} Digital Certificates can confirm that the person with whom you communicate is the one, who is claimed to be. For this, at the beginning, an interested person have to go to the Certification Authority (CA) and prove that he/she is really the one, who is later will be claimed to be in the Internet. After verification, CA grant the person with the special cryptographic tools (private and public key). Later anyone can ask CA via the Internet whether the person who use this cryptographic tools is the one who is claimed to be. CA checks whether cryptographic tools received under request match with the one that were given to the person upon registration. If they match, CA confirms the validity. See Network Associates, Inc.: An Introduction to Cryptography, 1999.
While digital certificates can effectively resolve the problem of distinction between private and business customers, a research of the scale of the fraud has to be conducted in advance, as it can be insignificant for today.

4.3 Customers’ location

4.3.1 Weaknesses

The next step in digital supplies, after probable differentiation between private and business customers, is to properly determine VAT rate. For today, EU businesses have to levy single VAT rate on transactions to EU private customers and do not levy VAT on transactions to non-EU customers.\(^85\) Starting with 2015 EU businesses will have to be more precise and will have to determine customer's country in order to levy appropriate VAT. Non-EU businesses already have to determine customer's country for their supplies. From the technical point of view it is not a big difference, because in order to determine whether customer is from the EU or not his country has to be determined.

Namely identification of customer's country probably represents one of the biggest problems of the current EU approach. EU legislation requires reliance on a customer's self declaration with the verification by normal commercial means,\(^86\) whereas customer's self declaration alone is not sufficient. It is not clear what “normal commercial means” are and no definitions are given on the EU level. As it is mentioned on the EU informational website, member states' tax authorities will provide more information in this respect.\(^87\)

For additional verification of the customer's location the following means can be used: 1) payment information; 2) tracking/geo-location software; 3) nature of the supply.

For instance the United Kingdom (UK) accepts such means as additional confirmation of customer's location\(^88\).

\(^{85}\) No obligation exist under EU legislation. Nonetheless, EU suppliers still can be obliged to levy, collect and remit VAT, but at the country of destination, for instance like in Norway (see chapter 3.1)

\(^{86}\) Regulation (EC) 282/2011, art.23(2). 

\(^{87}\) Such information is non-bidding, thought it stated on official website. It can be used only for information purpose. [http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/e-services/article_1610_en.htm#a13](http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/e-services/article_1610_en.htm#a13) [Visited November 2011].

\(^{88}\) For instance UK, see HMRC VAT Info Sheet 05/03.
a) credit/debit cards' billing address;

b) country of credit/debit cards' issuing bank;

c) geo-location or proprietary software;

d) use systems that are configured to identify where the service is used and enjoyed (eg telecommunication suppliers);

With close examination one can find that actually none of these means is guaranteed to define customer's location.

Payment information

a) Credit/debit cards' billing address. To circumvent this method customers can use a false billing address. Nowadays, when financial institutions allow on-line management of the accounts, the billing address can be changed for a time of a purchase. Another possibility to bypass is to open an separate account specially for on-line purchases with the initially wrong billing address. Moreover, some suppliers can accept payments made via electronic payment systems that initially do not have any customer information\textsuperscript{89}, so called electronic cash.\textsuperscript{90} Nowadays such payment systems are not so popular, but with the time the situation can changed and they can become widely used for online payments.

b) Country of issuing bank or financial institution can not be fully reliable source as well. A customer can open accounts in foreign financial institutions and thus circumvent suppliers' verification.

Tracking/geo-location software

Technological means, that is tracking and geolocation systems, use customer's PCs or other devices which are used to access the Internet. These systems are widely used nowadays in the Internet. For instance, the language of web-pages can depends on customer's location or a specific advertisement can be shown for appropriate region. Geolocation and tracking systems mainly rely on customer IP address, a special number which is allocated to the every device of the Internet and is required for the

\textsuperscript{89} Unaccounted payment systems.
\textsuperscript{90} For more information on electronic cash see Usher (2008).
communication between devices. Various degrees of the accuracy for such systems are claimed by different sources, some mention 70%\(^1\) others 96%\(^2\). But it is clear that such accuracy does not provide the complete reliance on such systems.

Moreover, the structure of the Internet is designed in such way that it easily allows substitution of IP address. Services, which allow change of IP address and thus circumventing geo-location and tracking software already exist and are completely legal. They even constitute a special market in the Internet and can offer IP addresses of any country from a wide list for a small fee (approximately 8€).\(^3\) This is another reason, why technological means can not be deemed as reliable for verification of customer's location, because a customer can substitute his real IP address.

**Nature of supply**

Methods, which rely on the nature of supply, are based on such features of transactions as language, currency and a content. These means are too vague and surely can not be used as model for all ESS transactions. Currency, for instance, is usually automatically converted by financial institutions during transactions while language can be an not issue for a customer. A content of supply implies that ESS are created specially for the specific region and it is pointless to use them in another place. An example can be electronic maps of a specific country. Nonetheless, such kind of transactions constitutes only small part of all ESS.

**Summary**

It must be said, that the implementation of above mentioned means of verification of customer location technically is not a very hard task. Nonetheless, few vague moments arouse in this respect. It is unclear what suppliers should do in case when a customer's self-declaration contradicts to the one or another means of verification. For instance, the UK states that suppliers should “then rely on satisfactory alternative evidence if the match is unsuccessful”.\(^4\) Manual processing of such supplies can be unfeasible task for supplies, therefore, they probably have to implement additional third

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\(^1\) Reidenberg (2002), p.268.
\(^2\) OECD Guidance 3, p.7.
\(^4\) HMRC VAT Info Sheet 05/03.
level of verification. Though it is still unclear whether it would be treated as “satisfactory alternative evidence”.

Another vagueness is connected with the necessity to show prices to a customer before a sale. Some countries can require including VAT in an advertisement.\textsuperscript{95} Therefore, in some cases, suppliers have to determine customer location even for the purpose of an advertisement, which can make additional inconvenience for suppliers.

Yet, probably the biggest hurdle in determining of customer location can be in customers themselves, in their ability to avoid taxation by incorrect statements. Despite the fact that it is not particularly easy for an average private customer to circumvent above mentioned means of verification, there is a risk of the appearance of the special services that can provide ad hoc solution for circumvention. For instance, website www.usunlocked.com\textsuperscript{96} proposes to a user from any country of the world, including the EU, a range of services. A customer can receive US shipping address, a debit card issued by US bank with US billing address and US IP address all at one. Website even offers personal shopping services, when a user says what he wants to buy and the US registered person makes a purchase. It is clear that with the help of such services customers can easily circumvent current verification methods. With the lapse of time when e-commerce becomes more common, services similar to above mentioned can become popular. It is worth mentioning, that suppliers of such services can operate legally, because their services are legal as such, despite the fact that they are mainly used for illegal purposes.

It seems that technological development, as opposite to anticipated assistance, offers nothing more then new services for circumvention. Thus the dissatisfaction from the business can be understood, when they are required to use means which are costly to implement and possible to circumvent.

\section*{4.3.2 Possible solutions and improvements}

To summarize, it shall be said, that customers' self-declaration is the main source

\textsuperscript{95} For instance “Products advertised in outlets, magazines, on the internet, or shown in catalogues, price lists and other literature may be aimed at the consumer, businesses, or both. If they're only meant for the general public, they'll show you a price including VAT. This is a legal requirement.” http://www.hmrc.gov.uk/vat/sectors/consumers/basics.htm\#3 [Visited November 2011].

\textsuperscript{96} Visited November 2011.
for suppliers in determining the country of destination and, accordingly, in determining of the appropriate VAT rate. As a customer can have financial incentives to incorrectly declare his locations, in order to avoid levying of VAT, this method is not considered as reliable. Other examined above methods that are used as supplementary to self-declaration also have flaws.

Unfortunately, for now, there were no new effective means found that would be robust to circumvention. Current approach, to combine few different means of verification, which independently do not guaranty an required level of identification, is the best option from all available. Verification of customer location by using information about the country of issuing bank probably can provide the most reliable result, as it is not particularly easy for an average customer to open an account in an foreign financial institution. Though, ad hoc services that appear in the Internet and can allow to circumvent means of verification are surely represent some threat.

Future solutions could rely on financial institutions, as they are compulsory link between suppliers and consumers. “Know-your-customer” rules\(^ {97}\) already require from financial institutions to collect information about a person, who is open an account. Bank For International Settlements\(^ {98}\) also recommends to collect, among other things, a customers' permanent address.\(^ {99}\) Thus, there is a possibility to oblige financial institutions to participate more actively in determining customer location. However, the feasibility of such approach should be examined more thoroughly, which falls out of the scope of this thesis.

4.4 Enforcement

4.4.1 Weaknesses

Previously mentioned flaws of regulation are turned towards suppliers of ESS, but they carry serious troubles for the EU member states as well. Member states have to be able to control the fulfillment of their obligations and enforce them where it is necessary. In B2B transactions the EU member states can easily inspect business

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\(^{97}\) Customer due diligence and record-keeping, see FATF (2003) 40 Rec.

\(^{98}\) Intergovernmental organization of central banks. It works out recommendation for central banks, which, in turn, have influence on financial institutions.

customers, which have obligation to self-assess and remit VAT. At the same time in B2C transactions VAT obligations are imposed on foreign suppliers, which probably are neither established nor have any physical connection with an EU member state. How can member states force a foreign legal entity to comply with their legislation?

The official web-site of the EU Commission states that the system is based on the voluntary compliance and only businesses which are fundamentally “anti-tax” will evade taxation. Such an argument can hardly be accepted. From one side, businesses can clearly see advantages in lower prices, which do not include VAT, and in higher profits, which follow from the tax evasion. From another side, member states have no effective means to put to an end such illicit activity in respect to overseas suppliers. Even those suppliers who are originally “tax-friendly” will be forced to evade VAT by fundamentally “anti-tax” businesses. In the competitive market there will always be players who will not comply with law in absence of due enforcement. Obviously, such businesses will have better prices than “tax-friendly” businesses and the latter will have to leave the market or begin to evade VAT as well. At the end such “race to the bottom” can theoretically lead to mass non-compliance to the tax law. One can say that such situation is more possible in Small and Medium Business (SMB) segment of the market. Enterprise businesses are expected to fulfill VAT obligations and probably not because of good will, but because of the physical presence in the EU and, therefore, can be reached by EU tax authorities. Such physical presence can be represented by a fixed establishment, a representative, an affiliated company or even by tangible supplies. As practice shows, physical presence can be used by the countries to enforce their law.

Another problem for the states is the inability to see and to control transactions of digital services. Supplies of conventional goods can be easily monitored and, if necessary, seized on a border, while ESS are supplied via the Internet where the very fact of the transaction is unseen for a member state. Thus, countries are not only unable to enforce their law, but even unable to find out the very fact of the violation of the law.

But troubles do not end here. Even when non-EU suppliers state that they collect


VAT on their transactions it is much harder, in comparison with the conventional means, for a tax authority to verify whether they really remitted it to any EU member state. Supplier can be registered under the Special Scheme in another member state, he can be VAT registered as non-established supplier in a given member state or can have an establishment in another member state. Thus the process of verification for tax authorities is much more complicated.

As a result, it can be presumed that tax authorities do not very actively try to prosecute foreign suppliers of ESS for noncompliance, as they do in respect to local suppliers of conventional goods and services.\(^\text{102}\) It certainly can influence the suppliers' opinion on whether or not to collect taxes on transactions to EU private customers and, as the result, significantly contribute to the VAT evasion.

4.4.2 Assessment

As countries are struggling to find an effective mechanism of influence on foreign suppliers, alternative methods of tax collection should be considered. For instance, the problem probably can be resolved by removing the obligation to collect and remit taxes from suppliers on: a) Customers; b) Financial institutions; c) Internet Service Providers (ISPs). Thus, the necessity to enforce suppliers to collect taxes can be avoided.

These options were widely discussed by both academics\(^\text{103}\) and legislators. For instance, the OECD, as the body responsible for the elaboration of an international approach towards e-commerce, conducted an research of possible alternatives.\(^\text{104}\) Key elements, advantages and disadvantages of above mentioned options are stated below.

**Customers' self-assessment**

While this method suits well for B2B transactions, when business customer self-assesses VAT, the application of self-declaration to B2C transactions is connected with some complexities.\(^\text{105}\) Firstly, private customers probably have even stronger incentive to avoid tax collection than business customers. When tax authorities do not have effective mechanism to detect and control supplies of ESS in the Internet, customers'...
tax avoidance can significantly increase. Secondly, while business customers, or other legal entities, are well aware about tax obligations and usually have educated personnel for carrying out tax tasks, some private customers can be ignorant in this respect. Therefore, substantial educational work has to be carried out before and during the implementation of the method.

Thus, despite such advantages as simplicity in realization, private customers’ self-assessment was not supported as the reliable method of tax collection neither by the EU, nor by the OECD.

**VAT withdrawal by financial institutions**

The idea is to collect VAT by financial intermediaries\(^\text{106}\) (e.g. credit cards companies, banks) at the moment of the transaction and transmit it later to an appropriate country.\(^\text{107}\) The main advantage of the method is that financial institutions do not have incentives for tax evasion. Customers can be interested in evading VAT in order to get better prices, the same as the suppliers. Financial institutions, in turn, are independent from both parties and do not have motives to evade tax collection. This is considered as the main advantage of the method and can effectively fight back problems of non-compliance. However, it also has weaknesses that do not allow to adopt such approach.

Generally speaking, under this method the burden of tax collection is moved from supplier to financial institutions and inherits the same complexities with verification of the customer location.\(^\text{108}\) In addition, financial institutions have to make a distinction between supplies of ESS and conventional goods. VAT has to be withheld only on ESS, while other supplies have to be free from VAT. Information, which will allow distinguishing supplies is supposed to be received from suppliers, which eventually leads to the same problems when suppliers can indicate the wrong kind of an transaction to avoid taxation. Moreover, an effective mechanism of VAT remittance from financial institutions to appropriate tax offices has to be created. Problems can

\(^{106}\) For instance, OCDE in its OECD TAG Report (2000a) refers to the notion of “Trusted third party”, which embrace the notion of financial institutions.


\(^{108}\) See Chapter 4.3.
appear because some financial institutions can opt out from the common approach.\textsuperscript{109}

Therefore, the method of VAT collection by financial institutions has complexities with the realization.

\textbf{VAT collection by ISPs}

This method presupposes to impose obligations of VAT assessment, collection and remittance on ISPs.\textsuperscript{110} As there is usually a chain of ISPs between a supplier and a customer, at least two possibilities exist. First is to impose the obligation on suppliers' ISPs.\textsuperscript{111} In this case, the necessity to create a mechanism of VAT remittance from ISPs to the appropriate tax office exists, because a supplier is situated in a different country from the tax office. Another hurdle is that a customer is unknown to a suppliers' ISP in cross border supplies and it makes tax collection by ISPs more problematic.

Second possibility is tax collection by customers' ISPs,\textsuperscript{112} which is usually located at the same country with the tax office. Moreover a customer, in most cases, is known to an ISP, because of a contract on providing of internet services. This proposal is more viable and it has the same advantage as the method with financial institutions, as ISPs do not have direct incentives to avoid tax collection.

Nonetheless, it has serious flaws. To begin with, it is not necessarily a person entered into a contract with an ISP who is making a purchase of ESS. For instance, a customer can make a purchase from an publicly accessed internet connection, such as an internet cafe or an employer's office. In case of open public wireless networks, which provide access to the Internet and are very popular now, it is almost impossible to identify customers and thus to collect VAT.

Another complexity is that such method will require from ISPs to scan all traffic in the attempt to find transactions involving purchases of ESS. Moreover, despite the fact that an ISP transmits data from customers to suppliers, it cannot always see the content of the data. Encryption methods are used precisely for the purpose to hide the content from any person between a sender and a receiver. For encryption it does not matter

\textsuperscript{109} For instance, “offshore financial centres”, which have high level of banking secrecy and anonymity.
\textsuperscript{110} Internet Service Provider (ISP) also can be considered as a trusted third party.
\textsuperscript{111} Lighthart (2004), p.15.
whether it is an ISP, with the purpose of taxation, or a thief. Taking into account that almost all online purchases are encrypted it can be almost impossible for ISPs to find them, not to mention other details of purchases.

Therefore, ISPs also can not substitute suppliers for the purpose of VAT collection.

Involvement of the supplier's tax office

As the removal of tax obligations from suppliers and imposing it on other tax intermediaries can not be accepted, because of different reasons discussed above, other options have to be considered.

For instance, VAT collection not by a customer's tax office, but by a supplier's tax office. In this case a supplier and a tax office will be in the same country, and thus the latter has more options to enforce the supplier to comply with VAT obligations. As transactions of ESS\textsuperscript{113} should be governed by the destination principle, the seller's tax office, at some point, would have to transfer collected VAT to the appropriate customer's tax office. Therefore, a movement of tax will be the following: 1) the supplier collects VAT; 2) the supplier remits it to its own tax office; 3) the suppliers tax office transfers VAT to the customer's tax office. The realization of the latter stage is most the problematic under this method. Yet, such approach as collection of taxes by foreign tax office and then transfer to the appropriate tax office, have already been implemented in the EU Special Scheme for ESS.\textsuperscript{114} So why not accept it on an international level, for instance by the OECD, and thereby improve the situation with the enforcement of VAT obligations? It seems that the serious problems are connected with the realization of the method on the global scale. The opinion of the OECD was following: “extremely high level of international co-operation between tax authorities and as such might not only be unrealistic in the near term but difficult to achieve in the long term as well”.\textsuperscript{115} The realization of the given approach in the EU was possible because of the significant cooperation between the member states. To achieve such level of cooperation on an international level is almost impossible task. Political tensions between countries will definitely affect an interaction between respective tax offices and therefore the VAT

\textsuperscript{113} See Chapter 4.5.2.
\textsuperscript{114} See Chapter 3.5.2. Though in EU scheme foreign tax office do not have advantages in enforcement, because non-EU suppliers are in another jurisdiction towards him.
\textsuperscript{115} OECD TAG Report (2000a), p.5.
collection.

Thus, the idea to substitute suppliers with suppliers' tax offices for the purpose of tax collection also seems unrealistic.

4.4.3 Possible solutions and improvements

As it stems from the previous sub-Chapters, the options that substitute suppliers in tax collection have significant flaws. Proposals that just supplement, but do not change the current approach, are examined below. Nonetheless, the feasibility, the effectiveness and costs of the realization are decisive factors here and they should be considered before an implementation.

Agreements with foreign countries to facilitate VAT compliance

The first proposal is to involve suppliers' countries into cooperation. It is much easier for them to reach suppliers as they are situated at the same country. Suppliers' expectations of possible actions from their own countries can induce them to comply with obligations of foreign countries. Therefore, the additional administrative influence on suppliers by the home country can lead to the proper level of compliance.

The adoption of a common approach to tax enforcement on an international level seems difficult.\textsuperscript{116} Probably, the bilateral agreements with countries can provide a better flexibility. As the majority of suppliers are situated in several highly developed countries, it would be sufficient to enter into agreements only with these countries.

However, countries that do not impose an obligation to collect taxes on foreign suppliers can be reluctant to enter into such kind of agreements. For instance, US law does not require from foreign suppliers to collect consumption taxes\textsuperscript{117}. Thus, helping the EU, the US can not expect the same actions in return, and therefor other privileges for the participation have to be found.

A legal bases the can oblige local suppliers to comply with foreign obligations also has to be examined. When companies conduct economic activity in a foreign country, it can be accepted, that they have to comply with a law of that country. Nonetheless, it is

\textsuperscript{116} Nonetheless with the growth of trade in ESS, the idea to create international body, which will specialize in enforcement of ESS tax law can be more viable.
\textsuperscript{117} See supra note 58.
hard to expect that an independent country will actively enforce its own businesses to comply with a foreign law.

Thus, the proposal is quite broad and vague. Nonetheless, it can have a potential and it can be the effective measure to increase compliance with VAT requirements.

**Intra-EU body that will facilitate tax compliance**

Another good opportunity to increase compliance is to create an intra-EU body, which will address issues connected with ESS. Current intra-EU bodies, which deal with the issues brought by rapid development of technology, such as “Body of European Regulators for Electronic Communications (BEREC)”118 and “Article 29 Data Protection Working Party”119 can be a good example. The proposed body can consist of representatives of state tax authorities, the EU Commission and technical specialists. Joint activities of all tax authorities through such EU-body can be more effective, than separate efforts of each tax office. The necessity in such body will be even more topical starting with the year 2015, when EU B2C suppliers of ESS will move to the destination principle.

### 4.5 International divergence

#### 4.5.1 Weaknesses

One can say that taxation at the place of destination, adopted by the EU, leads to the diversity of law at the international scale. It forces businesses to know and to comply with the great variety of rules, which are passed by different countries.

“companies find it inordinately difficult to determine their tax remittance obligations in thousands of jurisdictions with different and constantly changing tax rates, definitions, and reporting requirements. [...] An origin-based system in principle can reduce these costs.”120

 Suppliers have to monitor changes in legislation and must have a separate accounting to each country or union of countries. For SMB business it is sometimes

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118 “promote the development of the internal market for electronic communications networks and services” [http://erg.eu.int/](http://erg.eu.int/) [Visited November 2011].


costly to comply even with local legislation and could be almost impossible to comply with diverse legislation of various countries.

For instance, it could have passed unnoticed for suppliers of ESS that Norway adopted a similar to the EU approach,\textsuperscript{121} which requires collection of VAT on ESS by foreign suppliers. It, certainly, contributes to the diversity of law on international level.\textsuperscript{122} Actions required from, for instance, US suppliers upon the adoption of a new regulation somewhere in the world can be considered using this example. Firstly, the fact that Norway is not a member of the EU and has separate regulation of e-commerce itself could be not so obvious\textsuperscript{123} for US suppliers. Moreover, even some EU suppliers can be unaware of this fact, yet for the purpose of Norwegian legislation they are non-established persons, just like, for instance, US businesses. Secondly, suppliers would have to find out the fact of the adoption of new requirements, though it is unlikely that they constantly monitor changes in foreign law. Thirdly, suppliers have to register under Norwegian Special Scheme. Fourthly, in addition to the accounting under the EU Special Scheme, they receive a separate accounting under Norwegian Special Scheme.

If all countries in the world adopt the same approach as the EU and Norway did, it will be very difficult for suppliers to control all changes in law on the international level and being accounting before a variety of countries. It also will be impossible for small ESS suppliers to comply with such variety of requirements. It, in turn, can lead to the conscious restriction of the trade at the local markets or at the few most attractive markets.

Therefore, a common belief that the whole world is open even for a small supplier in the Internet has turned to be false. While the Internet itself does not have borders, tax

\textsuperscript{121} Bill on 10 December 2010. Press release, 13.05.2011 No.: 20/2011. \textsuperscript{122} Starting with 1st July 2011 non-established businesses supplying electronic services to Norwegian private customers are obliged to collect and remit VAT at the standard rate of 25%. Businesses are required to register in the Norwegian VAT Register or may use simplified scheme, which is similar to EU scheme. All interactions between the parties are possible to make from a distance by the use of the electronic registration and the online reporting system \texttt{http://www.voensnorway.com/} [Visited November 2011]) without a necessity in an establishment or a representative in Norway. \textsuperscript{123} Norway is a member of European Free Trade Association, which means that Norway participate in European Economic Area. It allows Norway to participate in EU's Internal Market without a conventional EU membership.
law of different countries tries to divide it, thus, eliminating the key advantage of the Internet.

Complaints also can be heard from countries that do not impose the burden of tax remittance on suppliers or do it in a limited manner. For instance, the US states should not levy “sales tax”\textsuperscript{124} on transactions from suppliers who do not have physical presence\textsuperscript{125} in this state. As a result, US suppliers of ESS\textsuperscript{126} do not levy consumption taxes on the transactions to other US states, but have to do it on the transactions to the EU member states. This situation is considered as unfair by such suppliers.

The variety of obligations of tax assessment, collection and remittance imposed by foreign countries leads to suppliers' dissatisfaction and unwillingness to comply. In conventional transactions businesses do accept international divergence in regulation because they know that their transaction can be stopped on the border and returned, in case of non-compliance. In the Internet there are no physical borders and many argue that they should not be imposed by countries\textsuperscript{127} or that it is even impossible to impose them. An alternative approach probably can be used instead of the current. For instance, removing consumption taxes from ESS, but at the same time increasing burden on income taxes, the one that companies will pay from income received from sales of the same ESS.\textsuperscript{128}

4.5.2 Assessment

First of all, it should be noted that this issue is better to address on an international level, rather then on national. Because of the transnational nature of the Internet, a solution of single country, or even the EU, can not resolve the problem, but only countries' common and unified approach can facilitate solution of the international divergence in regulation.

The most successful and recognized international body that tries to tackle issues of

\begin{small}
\begin{itemize}
\item \textsuperscript{124} “Sale tax” and “use tax” are consumption taxes in US. For more information, see reference in supra note 58.
\item \textsuperscript{125} Due to US Supreme Court decision in the case Quill v. North Dakota. For more information, see Ward (2006).
\item \textsuperscript{126} Those who are not participants of Streamlined Sales and Use Tax Agreement.
\item \textsuperscript{127} Barlow (1996).
\item \textsuperscript{128} Ivinson (2003), p.27.
\end{itemize}
\end{small}
taxation in e-commerce is the OECD. In the early days of digital trade, concerned countries decided to develop a common approach to taxation of e-commerce. The auspices of the OECD was chosen, as the economic organization, which represents opinions of the most influenced nations, though non-member countries were also invited into the discussion. In 1998 the international consensus was achieved at the Ottawa conference and the basic principles were stated in Ottawa Taxation Framework Conditions.\textsuperscript{129}

This framework has a vital importance for regulation of e-commerce. Firstly, it was adopted on the international level and thus, to some extent, fought back divergence in regulation. Secondly, it answered the basic and very important questions, which were and are still highly debated, such as: whether e-commerce should be taxed; whether new specific taxes have to be created; whether destination or origin principle should be applied to supplies of ESS.

Depending on answers to these questions, the necessity to comply with variety of law can be removed. For instance, if there will be no taxes on direct e-commerce, or there will be new special taxes with another mechanism of collection, or taxes will be collected at the place of origin, suppliers will not have to comply with the variety of law of different countries. Therefore, the viability of this options is considered below.

\textbf{Whether e-commerce should be taxed}

There were arguments that e-commerce transactions should be, at least temporary, exempt from taxation because of different reasons, such as insignificant turnover, infant stage of industry and overall complexities with imposition of taxes\textsuperscript{130} in the Internet.

The main argument against of such approach is that: “Taxation should seek to be neutral and equitable […] between conventional and electronic forms of commerce”\textsuperscript{131} That is, there should be no distortion in trade, which will be brought by exemption of e-services from taxation.

That is why such approach, in large, wasn't supported neither by academics\textsuperscript{132}, nor

\textsuperscript{129} OECD Framework (1998).
\textsuperscript{130} Good survey of the literature is found in Bird (2005), supra note 5. See also Basu (2007), p.245-246.
by the EU. On international level, the OECD agreed that: “Countries should ensure that appropriate systems are in place to control and collect taxes.”

Thus, a widely accepted approach is that direct e-commerce can not be exempted from taxation.

**Whether new specific taxes have to be created**

As the Internet is borderless and it is hard to implement conventional taxes to digital supplies, there is an option to create ad hoc taxes specifically for direct e-commerce.

For instance there were proposals to introduce a “bit tax”. The idea of this proposal is that the volume of data received from and sent to the Internet should be calculated and levied with tax. ISPs can easily calculate this volume, collect appropriate taxes and remit them to a tax authority. The advantage of such scheme is in its simplicity. Bit taxes can be easily collected by provider of the Internet, for instance, by inclusion them into the bill for the use of the Internet. Nonetheless, these taxes can be seen as taxation of the Internet itself, rather then services which are transmitted by means of it. As the result, there is no distinction not only between the value of the transactions, but also between free and paid services. “Bit tax” proposal was highly criticized by the OECD and rejected by the EU.

Another suggested idea, to substitute consumption taxes with additional income taxes, also did not find support. No new income taxes were introduced, moreover, countries agreed on “Developing options for ensuring the continued effective administration and collection of consumption taxes as electronic commerce develops”.

At the end, no new taxes were adopted and for today direct e-commerce is covered by the same VAT that applies to conventional services and goods.

133 “taxes on electronic commerce should be […]” at COM(1998) 374 final, p.2.
135 Chan (2000), supra note 128.
137 “While some commentators have suggested that there might be a need to look at alternative taxes such as "bit tax", the Commission is of the opinion that this is not appropriate […]” at COM(97) 157 final p.19.
Whether destination or origin principle should apply

The destination principle leads to the diversity of law on the international scale. However the origin principle, which is proposed in exchange for destination principle, has probably even more serious flaws. It induces suppliers to locate in low-tax jurisdictions and thus leads to the “race to the bottom” or “harmful tax competition” between the countries. It seems that countries consider this problem even more harmful then possible loss of some part of revenues with destination principle. Thus, participants of the Ottawa conference agreed that: “Rules for the consumption taxation of cross-border trade [in electronic commerce] should result in taxation in the jurisdiction where consumption takes place”.

Summary

Current approach (e-commerce [a] should be taxed by [b] consumption tax [c] at the place of the destination) leads to the necessity for business to comply with various law. As one can see from the analysis above, the international divergence in regulation was agreed on the international level. From the legislators' standpoint, the given approach is the lesser evil in comparison with other possible options.

Considering basic principles adopted by the OECD at Ottawa, the approach of the EU, as the approach of any other country that complies with these principles, doesn't look odd. As the principles were agreed on the international level, businesses should be ready that in the future even more countries will create their own requirements and accordingly contribute to greater diversity of regulation.

For instance, Norway already followed this way. In US similar tendencies can be seen. For now, it is not required from out-of-state suppliers to collect consumption taxes in the US. But it is customers who are pleased with such situation. The states, in turn, are more then dissatisfied with the loss of revenues. Therefore, unable to oblige suppliers, some states propose voluntary participation in the Streamlined Sales Tax

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140 As the result of the case Quill Corp. v. North Dakota. See also Ward (2006).
142 For now they can not force suppliers to participate in this project.
Project (SSTP). This project presupposes, similar to the EU, destination base registration. There were already attempts to adopt SSTP on the national level and thus make the participation compulsory.

Thus, one can say that countries gradually move towards taxation of ESS and being guided by principles adopted on the international level will contribute do the divergence in law.

4.5.3 Possible solutions and improvements

Despite inability to accept options proposed the previous sub-Chapter, some adjustments, which can fight back international divergence and significantly facilitate the compliance, can be adopted. For instance, the EU approach can be seen not as division of international regulation, but as unification of law of 27 EU member states. Instead of 27 different approaches, there is only one with clear rules. The Special Scheme creates one “point of entrance” for suppliers and simplifies the burden of compliance. It can be seen as the good remedy against division of regulation on the international scale. Countries, which represent the largest interest for business, can unite into few unions with a single place of registration, accountancy and control. It will be much easier for businesses to comply with requirements of few unions rather then with requirements of a variety of countries.

For instance, if Norway can join the EU Special Scheme, businesses will have to comply with one system instead of two independent systems. Participating in the EU Special Scheme, Norway can receive some benefits. If businesses could be accountable to one country (the member state of identification) instead of two (the member state of

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143 Suppliers, participants of SSTP, have to collect and remit consumption taxes in exchange of some privilege (such as simplified taxes, use of special software and in some cases tax amnesty) and the decrease of administrative burden. Swidler (2006), p.564.
146 It will be possible if European Free Trade Association (Iceland, Liechtenstein, Switzerland and Norway) will participate in the EU Special Scheme. This example is very superficial assumption to illustrate the overall approach. No legal analysis of such possibility was made and it can be impossible to implement in practice.
147 Even now, when there are limitations for B2C transactions, which are covered by origin principle, it can become possible to participate starting with the year 2015. Upon that time, there will be pure destination principle and Norway, theoretically, will receive the same revenues, as it supposes to have under its own scheme.
identification and Norway), probably more of them would comply with obligations and, as the result, larger revenue could be gained. Moreover, it will be much easier for Norway or any other country joining the EU Special Scheme to protect its interests and enforce its requirements being a part of the union. It also can fight back the situation when suppliers are just unaware of special requirements, for instance Norwegian, because it is much easier to miss the separate requirement of ten small countries, than one common requirement of the union of countries. Therefore, participation in the EU Special Scheme can be beneficial not only for foreign suppliers, but also for the countries.

As the disadvantage of such approach the dependency on foreign state should be mentioned. Probably the biggest part of revenues will be collected by foreign countries and it can be the political argument against the participation in a common union.

Nonetheless, it would be fair, if countries help businesses to comply with obligations. Division of the burden of taxation between suppliers, who bear additional costs to comply with regulation, and states, who accept the collection of revenues by other states, can be a fair solution.

Finally, businesses also have to change their attitude towards taxation of ESS. The idea that the Internet is an independent world, a cyberspace, where governments do not have sovereignty,148 seems not being sustained in practice. The main arguments of the international community and the EU are that taxation should be neutral and should not bring distortion depending only on the means of a delivery. Thus, if the overall approach to taxation of intangible goods is not changed, taxation in the Internet will be inevitable. Businesses should be ready that with the increased turnover in direct e-commerce states will become even more eager and more demanding to taxes.

148 The ideas of cyber-libertarian, see Barlow (1996).
Examples From Practice

5.1.1 Special Scheme

Weaknesses of current regulation mentioned in the previous sections certainly find reflection in the practice. It would be interesting to look at the estimated turnover of illicit trade in order to understand the scale of violation. Unfortunately the EU did not conduct such a study. Moreover, such turnover is extremely difficult to grasp and examine because of the intangible nature of supplies and the absence of borders in the Internet. However, some information is available. For instance, the EU Commission estimates that there will be over 200,000 participants of the Special Scheme starting with 2015, when it become available for EU businesses.\textsuperscript{149} Nevertheless, it was “well under 1000” registrants in 2004\textsuperscript{150} or more precisely 608 participants on July 1 2004.\textsuperscript{151}

It is interesting, that on January 1 2010 there were approximately 1,000, on May 12 2011 – 748 and on November 2011 - 431 participants\textsuperscript{152} of the Special Scheme. Despite the significant fluctuations, it is clear that nowadays the number of participants is lower than it was in 2004. Of course it can be argued that the significant part of the businesses opted to establish themselves in the EU rather then to use the Special Scheme, however it is more expected from Enterprise businesses that have such possibility. SMB segment of market, in its turn, is more expected to operate under the Special Scheme or, as one can presume from the numbers, completely evade VAT collection. Therefore, it is important to analyze in details causes that lead to the decline of the number of participants, because it can become the indication of the increasing level of non-compliance among suppliers. Nonetheless, such analysis fall out of the scope of this thesis.

The fact that almost half of all the participants (207\textsuperscript{153}) chose the UK for registration is predictable taking into consideration that the majority of participants are

\begin{footnotes}
\item [149] COM(04) 728 p.5
\item [150] Ibid.
\item [151] See Annex II Table 4
\item [152] See Annex II Table 4
\end{footnotes}
supposed to be from US, which shares the same language and has much in common with the UK. Rich information concerning the Special Scheme at the UK tax authority's official website and good information services can also contribute to such kind of popularity. And yet there are only 207 participants while it was 135 in August 2004, that is for the UK the increase only in 72 participants in 7 years. Considering significant growth of e-commerce in this period these numbers do not look very impressive.

To summarize one can say that above mentioned numbers can hardly be the indication of the success of the Special Scheme, moreover they should attract attention and are required to be analyzed more thoroughly.

5.1.2 Online suppliers

In this section few examples from practice are considered. They can show how suppliers implement or do not implement EU requirements. Nonetheless, it can be only the presumption of non-compliance. Such presumption is made on the basis of similar prices for US and EU customers and the simultaneous absence of any indication of applied VAT. Nonetheless, there is an existing possibility that VAT is collected and remitted to the appropriate tax authority. Moreover, during the survey no purchases were made, though it is unlikely that suppliers can silently withhold VAT in addition to stated price, without showing its value to customers.

Microsoft, Corp. (Microsoft) shows a good example of compliance with EU VAT requirements. Private customers can buy desired Microsoft software from the website “www.microsoft.com”, download it directly to their computers and immediately start using it. These online sales are held most probably in accordance with EU VAT requirements, at least it is indicated that prices for private customers from the UK and Germany include VAT. The rate is 19% probably because Microsoft, Corp. has a permanent establishment in an EU country with such VAT rate and thus can levy it on all B2C supplies within the EU. As Norway is not a part of the EU and has its own requirements, Microsoft can not levy the same 19% on supplies to Norwegian customers.

154 [http://www.hmrc.gov.uk][Visited November 2011]
155 See supra note 79.
156 Eden (2005), supra note 75 on p.228.
157 Survey was made in November 2011.
158 Annex II Figure 1 and 2.
customers. They have to pay 25% of VAT, the standard VAT rate in Norway. At the same time US citizens do not pay VAT, because it does not exist in the US.

Another software company, which offers electronic delivery of its goods, is Adobe Systems Incorporated (Adobe). It also provides the good example of compliance with EU requirements and levies VAT on digital supplies to EU private customers. UK and German citizens have to pay 21% of VAT, probably because Adobe, as Microsoft, has permanent establishment in an EU member state and Norwegian customers, predictably, are obliged to pay 25%.

Digital supplies of books, so called ebooks, also constitute ESS and thus have to be held in accordance with VAT requirements. For instance “Ebook.com” sells such ebooks for EU customers. On its website UK customers can buy digital version of a book for a price, which includes 20% VAT. The same VAT rate applies to Swedish customers and thus it can be assumed that the supplier is established in the EU country that has 20% of VAT rate. At the same time, US customers do not need to pay any VAT and therefore “Ebook.com” does not levy it. Yet, it seems that given web-site does not comply with the Norwegian VAT law. At least, it does not mention VAT on checkout page and the price is equal to the price of US customers. Thus, one can assume that “Ebook.com” complies with EU regulation, but fails to comply with Norwegian VAT obligations. This example can confirm that some suppliers that are originally VAT friendly can not fulfill their obligations because of inability to monitor legislation of all countries.

Another supplier Register.com, LP is the domain name registrar. On its website, “www.register.com”, businesses and private customers can buy a domain name. In addition to indication of possible application of VAT on transaction, it even has the explanation of how and why this mechanism works:

159 Annex II Figure 3.
160 Annex II Figure 4.
161 Annex II Figure 5 and 6.
162 Annex II Figure 7.
163 Annex II Figure 8.
164 Annex II Figure 9.
165 Annex II Figure 10.
166 Together with Register.com, Inc.
VAT is a European tax. Because Register.com, LP is based in Portugal, which is part of the European Union (EU), it must collect Portuguese VAT from all customers based in any EU country. Customers that are not EU residents are exempt from VAT. We use the customer's billing address to determine residency. We do not collect VAT from customers residing in the EU if they can provide a valid VAT Registration Number during check-out or in their wallet.\textsuperscript{167}

All above mentioned examples represent compliance with the EU regulation. Global corporations and EU businesses, as it can be seen from the given examples, preferably comply with VAT obligations, probably because of a physical connection with the one or another EU member state.

At the same time a lot of examples of sales only to local markets can be found. Unwillingness to conduct business activities in other countries can be explained by the anticipation of law profits, the restriction of trade by right owners or by the insufficient level of copyright protection in those markets. In the case of the EU it can also be due to the additional VAT obligations. For instance, famous in US book retailer Barnes&Noble, Inc. offers its e-books only to US residents.\textsuperscript{168}

The same applies to not less famous Amazon.com, Inc., which sells its digitally delivered music only to US residents through its website “www.amazon.com”.\textsuperscript{169} At the same time private customers from the UK, as probably from any other EU country, can buy an ebook at the same website “www.amazon.com”, but from another Amazon's company Amazon Digital Services, Inc. without VAT.\textsuperscript{170} Norwegian customers also do not have such burden and can buy an ebook free from VAT.\textsuperscript{171} This kind of activity is definitely contradicts to EU and Norwegian regulations. Noteworthy is the fact, that Amazon has the establishment in Luxemburg, Amazon EU Sàrl, which has special website for the UK market,\textsuperscript{172} “www.amazon.co.uk”.\textsuperscript{173} The price there, as is stated on

\textsuperscript{167} Annex II Figure 11.
\textsuperscript{168} Annex II Figure 12.
\textsuperscript{169} Annex II Figure 13.
\textsuperscript{170} Annex II Figure 14.
\textsuperscript{171} Annex II Figure 15.
\textsuperscript{172} Special localized websites for German (http://www.amazon.de), French (http://www.amazon.fr), Italian (http://www.amazon.it) and Spain (http://www.amazon.es) markets are also refers to this company. [Visited November 2011]
\textsuperscript{173} “This website (excluding “Marketplace”) is owned and operated by Amazon EU Sàrl.” http://www.amazon.co.uk/gp/help/customer/display.html/ref=footer_cou?ie=UTF8&nodeId=1040616 [Visited November 2011]
the web page, includes VAT and thus is in accordance with EU requirements. As the result, one can presume that US company Amazon Digital Services, Inc. does not comply with VAT requirements, while its EU establishment in Luxemburg, Amazon EU Sàrl, complies.

Now the suppliers which most probably do not comply with EU requirements shall be considered. For instance, US Company William S. Hein & Co., Inc. has a famous among legal scholars product “www.heinonline.org”. It is an internet service, which offers online access to legal information such as legislation, articles, law journals, etc. Access is provided by a subscription and can be bought by both businesses and private customers. Where businesses should self-assess VAT on overseas supplies, the price for EU private customers should includes VAT. However, the price for US, UK and Norwegian residents do not differ and in latter two cases do not have any mentioning of VAT.

NameCheap, Inc. offers similar to Register.com, LP service of domain name registration at their online website “www.namecheap.com”, but presumably this company does not collect VAT. The price is the same for customers from the US, the UK and Norway. Noteworthy is the fact, that the website controls the correctness of the UK postal codes, thus, clearly directs its activity to UK customers and differentiates them from customers from other countries.

Online sales of music is a fast-growing market where majority of US residents already prefer to purchase digital music files online rather than on conventional means such as CD or vinyl records. In the future digital formats can almost completely replace conventional means of music delivery. While currently a lot of online music suppliers restrict sales to their own markets, the same as sellers of video on demand do, some allow non-residents to make purchases. As an example one can mention US registered online music reseller Insound, LLC, which operates through its website “www.insound.com”. In addition to supplies of conventional CDs and vinyl records

174 Annex II Figure 16. Thought the price at UK website is lower, even including VAT, then in US website.
175 Annex II Figure 17, 18 and 19.
176 Annex II Figure 20, 21 and 22.
177 Annex II Figure 23.
178 emarketer.com (2011)
customers can choose online delivery of music. Herein Insound, LLC seemingly does not collect VAT from EU and Norwegian private customers as they have similar to US customers prices without mentioning VAT.  

Besides above mentioned examples of probable tax evasion, some US online suppliers have marks, that prices include all necessary taxes or they will be withdrawn during the payments. It is not clear what they mean by this statement, collection of US taxes or collection of any other appropriate taxes including EU VAT, and in the latter case whether they are really remitted to an EU tax authority or not.

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179 Annex II Figure 24, 25 and 26.
6 Conclusion

This thesis has shown that the EU approach in the consumption taxation of ESS can be roughly represented by such a statement: B2C ESS transactions \[1\] should be taxed \[2\] at the place of destination and VAT should be assessed and collected by \[3\] suppliers.\(^{180}\) However, this leads to various difficulties, the biggest of them could be summarized in the following text.

Firstly, some customers can avoid taxation by an incorrect statement of their location. The current available means of verification, because of their nature, do not allow fully counteract such activity.\(^{181}\) Existence and appearance of special internet services that allow customers to circumvent the means of verification can be the source for dishonest customers and can significantly contribute to a level of the infringement of VAT law. The presence of financial intermediaries, in almost all ESS supplies, can be used as a source for a new means to counteract illicit activity in future.

Secondly, the necessity to comply with diverse law on an international level\(^{182}\) can represent a hurdle for suppliers. The appearance of new obligations can be expected with the further development of regulations by countries, which can lead to unintentional non-compliance by suppliers. Nonetheless, measures can be taken to ameliorate this issue.\(^{183}\) Moreover, one can say that the Internet does not represents a separate space from the governments' point of view and has to be regulated equally with conventional trade.\(^{184}\) That is why suppliers have to accept the legislation of a country of destination, as they do it with conventional goods and services.

Thirdly, the absence of an effective means of influence on suppliers affects the ability of member states to enforce their law.\(^{185}\) Namely, the inability to enforce law is probably the biggest cause of a suppliers' non-compliance. This may lead to other

\(^{180}\) See chapter 3.3. The rule does not apply to intra-EU supplies till 2015.
\(^{181}\) See chapter 4.3.
\(^{182}\) See chapter 4.5.
\(^{183}\) See chapter 4.5.3.
\(^{184}\) See chapter 4.5.2.
\(^{185}\) See chapter 4.4.
similar problems that exist nowadays with the infringement of intellectual property on the Internet, where significant levels of violations is evidential for certain countries, but the current approach in the regulation of the Internet and the absence of an effective solutions does not allow to counteract it.

An assessment of the possible alternatives which can be proposed to counteract the above mentioned flaws has shown that the EU choose perhaps the most effective approach. Other alternatives have even bigger flaws or are highly difficult to implement in practice for various reasons.\textsuperscript{186}

Nonetheless, as it can be presumed from Chapter 5 that non-compliance nowadays can be on a rather high level. Though, a more detailed survey is recommended in this respect. Solutions proposed in this thesis can improve the situation to a certain level. Whether this level will be sufficient or not is hard to foresee. The core of the problems is highly likely to lie in the approach itself and when proposed solutions do not change the approach, but only supplement it, they can not completely resolve the problems.

It seems that, despite some criticism, the EU is currently satisfied with its current approach. However, one can say that such an approach consists of weaknesses and with the growth of trade in the ESS, all these weaknesses will have to be resolved.

\textsuperscript{186} See chapter 4.
7 References

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<table>
<thead>
<tr>
<th>Regulations</th>
<th>Description</th>
</tr>
</thead>
</table>
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Council Directive 2009/132/EC of 19 October 2009 determining the scope of Article 143(b) and (c) of Directive 2006/112/EC as regards exemption from value added tax on the final importation of certain goods, OJ L 292, p.5

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77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic means (Office for Official Publications of the European Communities).


HMRC VAT Info Sheet 05/03 HM Revenue & Customs VAT Info Sheet 05/03 Electronically supplied services: evidence of customer location and status

Electronic Commerce: Verification of Customer Status and Jurisdiction
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European Commission (29.11.2011) Gary Wilkinson, European Commission, DG Taxation and Customs Union. E-mail of 29.11.2011

HM Revenue & Customs (02.11.2011) Paul Whalley, HM Revenue & Customs. E-mail of 02.11.2011
8 Annex I


Section 2

General rules

Article 44

The place of supply of services to a taxable person acting as such shall be the place where that person has established his business. However, if those services are provided to a fixed establishment of the taxable person located in a place other than the place where he has established his business, the place of supply of those services shall be the place where that fixed establishment is located. In the absence of such place of establishment or fixed establishment, the place of supply of services shall be the place where the taxable person who receives such services has his permanent address or usually resides.

Article 45

The place of supply of services to a non-taxable person shall be the place where the supplier has established his business. However, if those services are provided from a fixed establishment of the supplier located in a place other than the place where he has established his business, the place of supply of those services shall be the place where that fixed establishment is located. In the absence of such place of establishment or fixed establishment, the place of supply of services shall be the place where the supplier has his permanent address or usually resides.

Subsection 8

Supply of electronic services to non-taxable persons

Article 58
The place of supply of electronically supplied services, in particular those referred to in Annex II, when supplied to non-taxable persons who are established in a Member State, or who have their permanent address or usually reside in a Member State, by a taxable person who has established his business outside the Community or has a fixed establishment there from which the service is supplied, or who, in the absence of such a place of business or fixed establishment, has his permanent address or usually resides outside the Community, shall be the place where the non-taxable person is established, or where he has his permanent address or usually resides.

Where the supplier of a service and the customer communicate via electronic mail, that shall not of itself mean that the service supplied is an electronically supplied service.

**Subsection 9**

**Supply of services to non-taxable persons outside the Community**

**Article 59**

The place of supply of the following services to a non-taxable person who is established or has his permanent address or usually resides outside the Community, shall be the place where that person is established, has his permanent address or usually resides:

(a) transfers and assignments of copyrights, patents, licences, trade marks and similar rights;

(b) advertising services;

(c) the services of consultants, engineers, consultancy firms, lawyers, accountants and other similar services, as well as data processing and the provision of information;

(d) obligations to refrain from pursuing or exercising, in whole or in part, a business activity or a right referred to in this Article;

(e) banking, financial and insurance transactions including reinsurance, with the exception of the hire of safes;
(f) the supply of staff;

(g) the hiring out of movable tangible property, with the exception of all means of transport;

(h) the provision of access to a natural gas system situated within the territory of the Community or to any network connected to such a system, to the electricity system or to heating or cooling networks, or the transmission or distribution through these systems or networks, and the provision of other services directly linked thereto;

(i) telecommunications services;

(j) radio and television broadcasting services;

(k) electronically supplied services, in particular those referred to in Annex II.

Where the supplier of a service and the customer communicate via electronic mail, that shall not of itself mean that the service supplied is an electronically supplied service.

CHAPTER 6

Special scheme for non-established taxable persons supplying electronic services to non-taxable persons

Section 1

General provisions

Article 357

This Chapter shall apply until 31 December 2014.

Article 358

For the purposes of this Chapter, and without prejudice to other provisions, the following definitions shall apply:

(1) ‘non-established taxable person’ means a taxable person who has not established his business in the territory of the Community and who has no fixed
establishment there and who is not otherwise required to be identified pursuant to Article 214;

(2) ‘electronic services’ and ‘electronically supplied services’ mean the services referred to in point (k) of the first paragraph of Article 59;

(3) ‘Member State of identification’ means the Member State which the non-established taxable person chooses to contact to state when his activity as a taxable person within the territory of the Community commences in accordance with the provisions of this Chapter;

(4) ‘Member State of consumption’ means the Member State in which, pursuant to Article 58, the supply of the electronic services is deemed to take place;

(5) ‘VAT return’ means the statement containing the information necessary to establish the amount of VAT due in each Member State.

Section 2
Special scheme for electronically supplied services

Article 359
Member States shall permit any non-established taxable person supplying electronic services to a non-taxable person who is established in a Member State or who has his permanent address or usually resides in a Member State, to use this special scheme. This scheme applies to all electronic services supplied in the Community.

Article 360
The non-established taxable person shall state to the Member State of identification when he commences or ceases his activity as a taxable person, or changes that activity in such a way that he no longer meets the conditions necessary for use of this special scheme. He shall communicate that information electronically.

Article 361
1. The information which the non-established taxable person must provide to the Member State of identification when he commences a taxable activity shall contain the
following details:

(a) name;

(b) postal address;

(c) electronic addresses, including websites;

(d) national tax number, if any;

(e) a statement that the person is not identified for VAT purposes within the Community.

2. The non-established taxable person shall notify the Member State of identification of any changes in the information provided.

Article 362

The Member State of identification shall allocate to the non-established taxable person an individual VAT identification number and shall notify him of that number by electronic means. On the basis of the information used for that identification, Member States of consumption may have recourse to their own identification systems.

Article 363

The Member State of identification shall strike the non-established taxable person from the identification register in the following cases:

(a) if he notifies that Member State that he no longer supplies electronic services;

(b) if it may otherwise be assumed that his taxable activities have ceased;

(c) if he no longer meets the conditions necessary for use of this special scheme;

(d) if he persistently fails to comply with the rules relating to this special scheme.

Article 364

The non-established taxable person shall submit by electronic means to the Member State of identification a VAT return for each calendar quarter, whether or not electronic services have been supplied. The VAT return shall be submitted within 20 days following the end of the tax period covered by the return.
Article 365

The VAT return shall show the identification number and, for each Member State of consumption in which VAT is due, the total value, exclusive of VAT, of supplies of electronic services carried out during the tax period and the total amount of the corresponding VAT. The applicable rates of VAT and the total VAT due must also be indicated on the return.

Article 366

1. The VAT return shall be made out in euro.

Member States which have not adopted the euro may require the VAT return to be made out in their national currency. If the supplies have been made in other currencies, the non-established taxable person shall, for the purposes of completing the VAT return, use the exchange rate applying on the last day of the tax period.

2. The conversion shall be made by applying the exchange rates published by the European Central Bank for that day, or, if there is no publication on that day, on the next day of publication.

Article 367

The non-established taxable person shall pay the VAT when submitting the VAT return.

Payment shall be made to a bank account denominated in euro, designated by the Member State of identification. Member States which have not adopted the euro may require payment to be made to a bank account denominated in their own currency.

Article 368

The non-established taxable person making use of this special scheme may not deduct VAT pursuant to Article 168 of this Directive. Notwithstanding Article 1(1) of Directive 86/560/EEC, the taxable person in question shall be refunded in accordance with the said Directive. Articles 2(2) and (3) and Article 4(2) of Directive 86/560/EEC shall not apply to refunds relating to electronic services covered by this special scheme.
Article 369

1. The non-established taxable person shall keep records of the transactions covered by this special scheme. Those records must be sufficiently detailed to enable the tax authorities of the Member State of consumption to verify that the VAT return is correct.

2. The records referred to in paragraph 1 must be made available electronically on request to the Member State of identification and to the Member State of consumption.

Those records must be kept for a period of ten years from the end of the year during which the transaction was carried out.
9 Annex II

<table>
<thead>
<tr>
<th>Country</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>0</td>
</tr>
<tr>
<td>Belgium</td>
<td>1</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>1</td>
</tr>
<tr>
<td>Cyprus</td>
<td>1</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>0</td>
</tr>
<tr>
<td>Denmark</td>
<td>3</td>
</tr>
<tr>
<td>Estonia</td>
<td>0</td>
</tr>
<tr>
<td>Finland</td>
<td>0</td>
</tr>
<tr>
<td>France</td>
<td>8</td>
</tr>
<tr>
<td>Germany</td>
<td>36</td>
</tr>
<tr>
<td>Greece</td>
<td>1</td>
</tr>
<tr>
<td>Hungary</td>
<td>0</td>
</tr>
<tr>
<td>Ireland</td>
<td>21</td>
</tr>
<tr>
<td>Italy</td>
<td>13</td>
</tr>
<tr>
<td>Latvia</td>
<td>0</td>
</tr>
<tr>
<td>Lithuania</td>
<td>0</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>65</td>
</tr>
<tr>
<td>Malta</td>
<td>1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>66</td>
</tr>
<tr>
<td>Poland</td>
<td>0</td>
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<tr>
<td>Portugal</td>
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</tr>
<tr>
<td>Romania</td>
<td>0</td>
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<td>Slovakia</td>
<td>0</td>
</tr>
<tr>
<td>Slovenia</td>
<td>0</td>
</tr>
<tr>
<td>Spain</td>
<td>2</td>
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<tr>
<td>Sweden</td>
<td>5</td>
</tr>
<tr>
<td>UK</td>
<td>207</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>431</strong></td>
</tr>
</tbody>
</table>

*Table 4: Information provided by UK tax office\(^{187}\) as of November 2011*

---

187 HM Revenue & Customs (02.11.2011)
<table>
<thead>
<tr>
<th>Date</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 July 2004</td>
<td>608</td>
</tr>
<tr>
<td>1 January 2010</td>
<td>Approx. 1,000</td>
</tr>
<tr>
<td>12 May 2011</td>
<td>748</td>
</tr>
<tr>
<td>Total exclusions of taxable persons by Member States</td>
<td>567</td>
</tr>
<tr>
<td>Total deregistrations by taxable persons</td>
<td>130</td>
</tr>
</tbody>
</table>

*Table 5: Information provided by European Commission*

188 European Commission (29.11.2011)
Figure 1
Figure 2
Figure 3
Figure 4
Figure 5
Figure 6
Figure 7
Figure 9
Figure 10
Figure 11
Figure 12
Figure 13
Figure 14
<table>
<thead>
<tr>
<th>Item(s) Subtotal: $12.03</th>
<th>Total for this order: $12.03</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Before Tax: $12.03</td>
<td>Tax Collected: $0.00</td>
</tr>
<tr>
<td></td>
<td>Grand Total: $12.03</td>
</tr>
</tbody>
</table>

Payment Information

Payment Method: Visa
Billing Address:
- 1234 Streeet
- SEATTLE, 98107
- Washington

Please note: This is not a VAT invoice.

Figure 15
World’s Largest Image-based Legal Research Database

Registration Confirmation

Log-In Information:
(Username) 
Email: 

Contact Information:
First name: 
Last name: 
Address: 
City: GLENROSSAL 
State: Other 
Zip code: IV27 6AR 
Country: GB 
Phone: 

Order Information: [modify subscription options]
Law Journal Library - 1 week ($64.95)
Total Cost: $64.95

Subscription Period:
Your subscription period begins immediately after your payment is received from PayPal.

Having trouble with your account? Contact Us.

©2010 William S. Hein & Co., Inc. All Rights Reserved.

Figure 17
Figure 18
<table>
<thead>
<tr>
<th>Log In Information:</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Username):</td>
</tr>
<tr>
<td>Email:</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Contact Information:</th>
</tr>
</thead>
<tbody>
<tr>
<td>First name:</td>
</tr>
<tr>
<td>Last name:</td>
</tr>
<tr>
<td>Address:</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Order Information:</th>
</tr>
</thead>
<tbody>
<tr>
<td>(modify subscription options)</td>
</tr>
<tr>
<td>Law Journal Library - 1 week ($64.95)</td>
</tr>
</tbody>
</table>

**Total Cost:** $64.95

*Subscription Period:*
Your subscription period begins **immediately after your payment is received** from PayPal.

---

*Figure 19*
Figure 20
Figure 21
Figure 22
Validation Error
Postal code is invalid. The zip code are the following any one of AN NA A AA AN A AA A A
NA A AN A A or A AA A A A A A The letters Q V and X are not used in the first position The letters I J and
Z are not used in the second position The only letters to appear in the third position are A B C D E F G H J K S T U and W The only letters to appear in the fourth position are A B E H M N P R V W X and Y The second half of the Postcode is always consistent numeric alpha alpha format and the letters C I K M O and V are never used.

Figure 23
Figure 24
Figure 25
**Billing / Shipping**

**Step 2 of 4**

You must enter a valid credit card number.

**1 Shipping Address**

<table>
<thead>
<tr>
<th>Name</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Address 1</td>
<td></td>
</tr>
<tr>
<td>Address 2</td>
<td></td>
</tr>
<tr>
<td>City</td>
<td>New York</td>
</tr>
<tr>
<td>State</td>
<td></td>
</tr>
<tr>
<td>Zip / Postal Code</td>
<td>10311</td>
</tr>
</tbody>
</table>

**2 Delivery Options**

No shipping fees for this order.

Download file will appear on the last step of checkout.

**3 Discounts**

<table>
<thead>
<tr>
<th>Gift Card</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

**4 Billing Information**

<table>
<thead>
<tr>
<th>Payment Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mastercard</td>
</tr>
<tr>
<td>Visa</td>
</tr>
<tr>
<td>American Express</td>
</tr>
<tr>
<td>Discover</td>
</tr>
<tr>
<td>Paypal</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Name on Card</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Card #</td>
<td></td>
</tr>
</tbody>
</table>

**5 Billing Address**

<table>
<thead>
<tr>
<th>Name</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Address 1</td>
<td></td>
</tr>
<tr>
<td>Address 2</td>
<td></td>
</tr>
<tr>
<td>City</td>
<td>New York</td>
</tr>
<tr>
<td>State</td>
<td></td>
</tr>
<tr>
<td>Zip / Postal Code</td>
<td>10311</td>
</tr>
</tbody>
</table>

“Your order is not yet complete! Please click "continue" for a final review!”

Continue

**Your subtotal**

$10.49

---

**Figure 26**