Reform of the VAT system: Frequently asked questions

See also IP/14/1216

What is VAT?
VAT is a consumption tax, charged on most goods and services traded for use or consumption in the EU. It is levied on the "value added" to the product at each stage of production and distribution. The "value added" means the difference between the cost of inputs into the product / service and the price at which it is sold to the consumer. VAT is charged when VAT-registered (taxable) businesses sell to other businesses (B-2-B) or to the final consumer (B-2-C). VAT is intended to be "neutral" in that businesses are able to reclaim any VAT that they pay on goods or services. Ultimately, the final consumer should be the only one who is actually taxed. Businesses are given a VAT identification number and have to show the VAT charged to customers on the invoices.

The VAT system in the EU is governed by a common legal framework - the VAT Directive. In the EU, there is a minimum standard VAT rate of 15%, above which Member States are free to set their own national VAT rates. Member States decide how to spend the revenue they receive from VAT receipts, except for a small percentage of this total (around 0.3%) which is paid towards the EU budget.

VAT is one of the main sources of government revenue for all Member States and one of the three own resources of the EU.

How does the current VAT system work?
Under the legislation currently in force a taxable person is any individual, partnership, company or whatever which supplies taxable goods and services in the course of business. The VAT due on any sale is a percentage of the sale price but from this the taxable person is entitled to deduct all the tax already paid at the preceding stage. In this way, the final VAT paid is made up of the sum of the VAT paid at each stage.

Goods supplied between taxable persons in different Member States are exempted with a right to deduct the input VAT if they are sent to another Member States. This is known as an "intra-EU supply". The VAT number of the taxable customer can be checked using the VAT Information Exchange System (VIES).

The VAT due on the transaction is payable on acquisition of the goods by the taxable customer in the Member State where the goods arrive. This is known as "intra-EU acquisition". The customer accounts for any VAT due in his normal VAT return at the rate in force in the country of destination.

VAT on supplies of goods to final consumers is paid at the place where the goods are located except for distance selling which is taxed in the Member State where the goods are dispatched.
VAT on services to taxable persons is paid at the place where the customer is established. The customer will account for VAT on the services in the Member State where he is established, applying the VAT rate of that country. VAT on services to final consumers is paid at the place where the supplier is established, unless a specific rule applies.

Depending on the nature of the service, VAT may need to be paid in another Member State than that where the taxable customer or the supplier is established. This is for example the case with services connected to immovable property; transport of passengers; cultural, artistic, sporting, scientific, educational, and entertainment services, e-services or telecom services.

Given that EU law only requires that the standard VAT rate must be at least 15% and the reduced rate at least 5% (only for supplies of goods and services referred to in an exhaustive list), actual rates applied vary between Member States and between certain types of products. In addition, certain Member States have retained separate rules in specific areas. The detailed application of VAT varies according to the administrative practices of each Member State within the framework set out by EU legislation.

Why is the Commission looking to fundamentally reform the current VAT system?

First, VAT must be made more workable for businesses. A simpler, more transparent VAT system would relieve businesses of considerable administrative burdens and encourage greater cross-border trade.

Second, VAT must be made more efficient in supporting Member States’ fiscal consolidation efforts and sustainable economic growth. Broadening tax bases and limiting the use of reduced rates could generate new revenue for Member States without the need for rate increases. The standard VAT rate could even be reduced in some Member States, without any impact on revenue, if exemptions and reductions were removed.

Third, the huge revenue losses that occur today due to uncollected VAT and fraud need to be stopped (see IP/14/1187).

Finally, the Commission has concluded that the long-standing question of changing to a VAT system based on taxation at origin is no longer relevant. Therefore, VAT will continue to be collected in the country of destination (i.e. where the customer is located), and the Commission will work on creating a modern EU VAT system based on this principle.

What reforms have already been introduced in recent years to improve the VAT system in Europe?

In December 2011, the Commission launched an ambitious reform of the EU VAT system (see IP/11/1508).

Among the core objectives of this Strategy were to make the VAT system more robust and fraud-proof, and to simplify VAT so as both to facilitate greater compliance and ease the lives of businesses across the EU.

Since this Strategy was launched, important progress has been made towards these objectives.

In terms of better fighting VAT fraud, an important proposal which has already been adopted is the Quick Reaction Mechanism (see IP/12/868), which will allow Member States to swiftly and effectively respond to new cases of massive fraud. Since 2010, Eurofisc has also been functioning as a very effective network to enable Member States to exchange information and intelligence on VAT fraud. The Fiscalis programme and the Commission
also support Member States in the exchange of best practices in various forums, and encourage national authorities to engage in joint audits where this could add value.

In terms of simplifying the VAT system, already at the beginning of 2013 important new legislation entered into force to encourage e-invoicing and ease administrative burdens for small businesses. On 1 January 2015, a one-stop-shop will come into effect for businesses supplying e-services or telecom services, to ease compliance for those operators. And the Commission has proposed a standard VAT declaration form which should greatly simplify the process of VAT returns for cross-border businesses in the EU (see IP/13/988).

In addition to action at EU level, national authorities also need to take all necessary measures to improve compliance and strengthening enforcement on VAT fraud. This has been strongly and consistently relayed to Member States through the country specific recommendations for better economic governance. While each national situation requires its own particular approach, measures such as simplifying the tax system and broadening the tax base, and clamping down harder on those that evade VAT, can make a considerable difference in terms of VAT revenues.