those already in existence and those in the process of being set up.

2.9. The Committee has on many occasions expressed its support for the principle of pre-accession aid for agriculture in the applicant countries. Whilst well aware that Community efforts are no more than a back-up for action taken at national level, and can never replace the efforts of the applicant countries themselves, there is now growing concern that the ECU 500 million to be earmarked annually for all ten CEEC applicants is downright inadequate.

2.10. The Committee would point out that the numbers of those employed in agriculture in the CEEC will fall dramatically in the next few years. The cost of providing urgently needed jobs and social protection, however, far exceeds the available resources of the common agricultural policy. The Committee therefore reiterates its proposal that, in addition to Phare, ISPA and SAPARD, a stand-alone fund financed largely from the EU budget be set up to cover the pre-accession period. Given current political discussions about a possible freezing of the EU budget, the Committee would point out that such action would inevitably have a serious impact on the proposed pre-accession programmes.

Brussels, 27 January 1999.

The President

of the Economic and Social Committee

Beatrice RANGONI MACHIAVELLI

Opinion of the Economic and Social Committee on:

— the 'Proposal for a Council Directive amending Directive 77/388/EEC as regards the rules governing the right to deduct Value Added Tax', and

— the 'Proposal for a Council Regulation (EC) on verification measures relating to the refund system and administrative cooperation measures necessary for the application of directive 98/xxx/EC' [1]

(1999/C 101/17)

On 27 July 1998 the Council decided to consult the Economic and Social Committee, under Article 99 of the Treaty establishing the European Community, on the above-mentioned proposals.

The Section for Economic and Monetary Union and Economic and Social Cohesion, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 15 December 1998. The rapporteur was Mr Walker.

At its 360th plenary session (meeting of 28 January 1999) the Economic and Social Committee adopted the following opinion by 99 votes to eight, with five abstentions.

1. Introduction

1.1. As a result of the changes made to the common VAT system by the transitional arrangements, it was possible to eliminate, on 1 January 1993, the checks and administrative procedures prior to or on crossing an internal border of the European Union, while safeguarding to the maximum the Member States' discretion for determining their national VAT systems, in particular by retaining a large number of options and powers in the Directive.

1.1.1. However, the abolition of physical barriers placed greater emphasis on the intangible obstacles to trans-national activities faced by businesses.

1.2. The wide variety of rules for determining the place where a transaction is taxed and, consequently, the place where the tax is deducted or refunded, and the

[1] OJ C 219, 15.7.1998, pp. 16-20.

lack of uniformity in the way in which the present system of VAT is applied, means that the Single Market is effectively segmented into fifteen tax areas, creating confusion, additional workloads, administrative complication and legal uncertainty for traders. Thus, traders have to know the law, and the way in which it is applied, in each Member State where they carry out taxable transactions and in those Member States where they incur VAT-bearing expenditure.

1.2.1. Conversely, traders can exploit these differences by using clever tax accounting or manipulation, and this distorts that fairness of competition which is supposed to be the hallmark of the Single Market.

1.3. In July 1996, the Commission presented a work programme accompanied by a timetable of proposals for the introduction of a genuine common system of VAT suited to the demands of the Single Market. Under this programme, Community action will be based on three pillars:

— more uniform application of the tax;

— modernization of the tax, and

— a change in the taxation system (place of taxation).

1.4. However, independently of the move to a system of taxation at the place of origin, the Commission considers that it is now an urgent necessity to modernize the general provisions of the present system and to achieve more uniform application. This phase has become the absolute priority of the work programme.

1.5. In a working paper dated 14 May 1997, the Commission also indicated that VAT obligations should be one of the sectors to be covered in the second phase of the SLIM (Simpler Legislation for the Internal Market) initiative. The Commission felt that there was a need for the immediate examination of simplification measures which would reduce the burdens on business in the short term and, at the same time, pave the way for the introduction of the new common system of VAT.

1.5.1. The working party set up to examine the subject identified the VAT refund procedure laid down in the Eighth VAT Directive as one of the subjects which is in urgent need of simplification.

1.5.2. Following the work of this group, the Commission report on the SLIM initiative, approved by the Internal Market Council on 27 November 1997, recommended a study of how to achieve a radical reform of the existing refund procedures in the Eighth Directive.

1.6. The first section of the proposed Directive is the outcome of this study. The objective of the proposed measures is to simplify the procedures enabling taxable persons established in the Community to recover the tax paid in a Member State in which they are not established.

1.6.1. The second section concerns expenditure not eligible for a full deduction of VAT. This section forms part of the exercise of modernizing the present system and ensuring its more uniform application. The objective of the proposed measures is to approximate the national rules, which are currently very divergent in this area. The need for this approximation has been intensified by the judgement of the European Court of Justice in the Aro Leasing [1] case.

1.7. There is also a proposal for a regulation on the measures for verification, the system for recovering tax refunded to traders from the Member State in which the expenditure was incurred and on the administrative cooperation which will be required.

1.8. The two sections of the proposed Directive, at first sight independent of one another, are deemed to be inseparable if the neutrality of the tax is to be assured.

1.8.1. Firstly, if the rules governing the refund/deduction of tax paid in a Member State where the trader is not established were amended without approximating the right to deduct, this would provide a solution to existing distortions of competition but would create new distortions, in particular for suppliers of services who were in direct competition on the market of a given Member State and who were subject to different deduction rules. Secondly, VAT is not fully deductible under the proposed expenditure rules and Member States retain a margin of discretion. The change in the refund procedure prevents traders from exploiting any resulting differences, so as not to create situations of unfair competition.

2. **The Commission proposals**

2.1. *Deduction of the VAT paid in a Member State where the taxable person is not established*

2.1.1. The Sixth VAT Directive establishes the principle that every taxable person is entitled to the deduction or refund of VAT, regardless of the Member State in which the VAT-bearing expenditure was incurred.

2.1.2. The Eighth VAT Directive harmonized, throughout the EU, the arrangements for the refund of

[1] Judgement of the Court (Sixth Chamber) of 17 July 1997. Case C-190/95. European Court Reports 1997 p. I-4383.

VAT to taxable persons established in a Member State other than that making the refund. The main objective of that Directive is to place taxable persons who are not established in the Member State where they pay VAT on a similar footing to taxable persons established in that Member State, who exercise their right to deduct by directly setting-off the tax on their periodic returns.

2.1.3. In practice, the operation of the Eighth Directive refund procedure poses considerable problems both for traders and the national administrations of the Member States. On the one hand, traders find that they are exposed to long-winded procedures and, sometimes, adversarial attitudes which make it pointless to pursue a claim; on the other hand, national administrations are involved in time-consuming and tortuous verification processes that yield no gain to their national exchequers.

2.1.4. In the light of this situation, the Commission has decided that remedial action is both necessary and urgent. The details of the Commission's proposals are set out in Appendix 1.

2.2. *Expenditure which is not eligible for full deduction*

2.2.1. Without further harmonization of the rules governing the right to deduct, the changes created by the Commission's proposals on the place of deduction would have the effect of increasing the distortion of competition because of differences between the rules of the state where tax is paid and that where it is deducted.

2.2.2. The Commission's proposals are set out in Appendix 2.

2.3. *Verification, refund and administrative cooperation procedures*

2.3.1. The Commission's proposals for a regulation governing the procedures for verification, the claiming of refunds by Member States granting deductions from the Member State in which the expenditure was incurred and administrative cooperation procedures are set out in Appendix 3.

3. **General comments**

3.1. In its opinion dated 11 July 1997 on the Commission proposals for a new common system of VAT [1] the Committee stated that 'The Economic and Social Committee considers that the imminence of a substantial change to a definitive system should not be allowed to obscure the need for interim reforms to the existing transitional system, which should then be carried forward into the new definitive system.' It therefore welcomes the present proposals as being entirely consistent with this view. At the same time, the Committee is concerned by the length of time which it is taking to implement the new common system of VAT and would not wish the updating of the transitional system to have the effect of impeding or delaying the introduction of the new definitive system.

3.2. The Economic and Social Committee has repeatedly expressed its strong support for the SLIM Initiative and therefore endorses the Commission's proposal to implement the recommendations for the reform of the Eighth Directive procedures which have been put forward under this initiative.

3.3. It is generally acknowledged that the Eighth Directive refund procedure has fallen into widespread disrepute both amongst traders and the representatives of national administrations. At best, the procedure is so complicated and time-consuming that traders are exposed to uncertainty and frequently consider it more cost-effective not to submit a claim while, in the worst cases, the stance adopted by some Member States is so obstructive that pursuing a claim is largely a waste of time.

3.4. The result is that, in an unacceptably high proportion of cases, traders are effectively discouraged from obtaining a refund. They are therefore being deprived of a right which is conferred upon them by the Sixth Directive. This is incompatible both with the basic principles of VAT and the concept of a Single Market.

3.5. By the same token, national administrations find the procedures so complex and costly to administer that the vast majority of them have sought derogations. Clearly, a system in which derogations are the rule rather than the exception must be fundamentally flawed.

3.6. The Commission has also established a convincing case that the present situation leads to distortions of competition. It must be recognized that absolute equality of competition is an ideal towards which one should strive while accepting that,

a) it can never be wholly achieved; and,

b) each successive step along the way involves additional cost and the nearer one approaches to total equality the more exponential the increase in cost becomes.

3.6.1. It is worth bearing in mind that the costs involved are not only financial but also political, in terms of the inevitable loss of sovereignty.

[1] OJ C 296, 29.9.1997, p. 51. (Rapporteur: Mr Walker).

3.6.2. Therefore, although the Member States would be obliged, under the present proposals, to forego some of the options which they currently have to impose limitations on the right to deduct and apply national interpretations to the definition of what constitutes an allowable business expense for VAT purposes, this can be justified by the need to eliminate or reduce distortions of competition.

3.6.3. In this context, it is important to remember that, even where the level of distortion is not high in terms of the overall balance of trade, it may result in significant sectoral distortions which erode the fairness of competition in those sectors affected.

3.7. The Economic and Social Committee accepts the proposition that the two sections of the proposal are inextricably linked if the neutrality of the tax is to be ensured.

3.8. The Economic and Social Committee also accepts that the discretion given to Member States at present, and the differences of interpretation and application which exist between different Member States, exposes the system to the risk of tax fraud and legitimate manipulation.

4. **Specific comments**

4.1. *Deduction of the VAT paid in a Member State where the taxable person is not established*

4.1.1. The primary aim of this section of the present proposal is simplification of the existing procedures.

4.1.2. The Economic and Social Committee agrees with the Commission that the only change which can significantly simplify the current system is to permit traders to deduct VAT paid in Member States where they are not established by setting it off against the tax due in the Member State or Member States where they are registered for VAT.

4.1.3. Where the taxable person is only identified in a single Member State, this should create no problems because all tax paid within the Community will be deducted in that Member State, regardless of where it was incurred, provided that it relates to legitimate business expenditure.

4.1.4. However, were this section to stand alone, this would still lead to distortions of competition because the various Member States would apply different rules in deciding what was, and what was not, legitimate business expenditure in this context. That is why the two sections are inter-dependent and must be seen as a single proposal; neither will achieve the desired effect without the other.

4.1.5. Where the taxable person is registered for VAT in more that one Member State, the situation becomes more complicated because situations can arise where it is difficult, or even impossible, to determine the country in which the taxable transactions (to which the goods or services on which tax has been paid relate) have taken place and, therefore, the country in which deduction should be permitted.

4.1.5.1. Take, for instance, the example of a lorry which is owned by a German company, is registered in the Netherlands and is used for transporting goods between the UK and Italy, in both directions. The company has physical establishments and is registered for VAT in both countries. The situation is complicated by the fact that in some cases the freight charges are paid by the supplier and in others by the recipient. It may be necessary to purchase fuel or tyres or replacement parts or to have repair work carried out on the vehicle during its journey through France, a country in which the company has no physical presence or VAT registration and carries out no taxable transactions. It could be very difficult in these circumstances to apportion the right to deduct between the UK and Italy on anything other than a purely arbitrary basis.

4.1.6. Nevertheless, this complication should not be seen as reducing the value of the Commission proposals, which represent a major improvement for both traders and national administrations over the subsisting situation with the Eight Directive.

4.1.7. The requirement for taxable persons to present supporting documentation, broken down by Member State, with their periodic returns, and to furnish copies of the invoices or import documents, constitutes an additional formality but the burden imposed by this on businesses will be a great deal less than that which they incur at present in making Eight Directive claims which are, in many cases, fruitless.

4.1.8. Under the Commission's proposals, the regulations governing the eligibility of expenditure for deduction would be those of the Member State of deduction and not those of the Member State where the expenditure was incurred, as at present. The Economic and Social Committee accepts the logic of this change. The Member State granting the deduction can, of course, obtain reimbursement from the Member State where the tax was paid.

4.2. *Expenditure which is not eligible for full deduction*

4.2.1. The objectives of this section are simplification of existing procedures and the elimination of distortions of competition. The latter can only be achieved by an element of harmonization.

4.2.2. It must be acknowledged that a great deal of expenditure on accommodation, food and drink can reasonably be regarded as legitimate business expenditure because it is incurred primarily for business purposes and would not have been incurred at all but for the demands of the business; if, for example, a businessman travels to visit a client and stays in a hotel, where he consumes a meal, this should be regarded as business expenditure because, were it not for the necessity of visiting his client, he would not have made the journey or stayed in the hotel or eaten that meal.

4.2.2.1. It is true that he would have had to stay somewhere and have eaten a meal, because shelter and food are primary needs, but he could have satisfied these needs by staying at home, where the shelter would have incurred no incremental cost and the meal would have been a great deal less costly.

4.2.2.2. By the same token, if a businessman takes a client to lunch, he does so in the hope of securing or retaining his business and this can also be regarded as a legitimate business expense.

4.2.2.3. However, it has to be conceded that charges of this nature are open to abuse, in that they are often ascribed to business activities when the primary purpose is not commercial and, while such opportunities exist, it would be naïve to expect that they will not be exploited.

4.2.2.4. Moreover, it is undoubtedly difficult for administrations to distinguish between legitimate and fraudulent claims or to verify the element of business expenditure where there has been a genuine combination of business and private consumption.

4.2.2.5. For these reasons, the Committee approves the Commission proposal to apply a flat-rate deduction limit of 50 % to charges of this nature as a practical and pragmatic solution.

4.2.3. The Committee agrees with the Commission that luxuries, however defined, should continue to be ineligible for deduction but believes that considerable scope will remain for differences in interpretation between the Member States on what constitutes 'luxury' expenditure, as this is largely a subjective judgement. Furthermore, it is not susceptible to a single definition, since what is considered a luxury in one context might not be so in another.

4.2.3.1. Differences between Member States in the interpretation and application of these rules will continue to give rise to some distortions of competition but the Economic and Social Committee considers that the level of distortion is unlikely to be significant in total or in its impact on any particular sector.

4.2.4. The Committee shares the Commission's view that entertainment expenses should be treated similarly to luxury expenditure, as in principle they fall under the heading of final consumption. There would therefore be no right to deduct value added tax in respect of entertainment expenses.

4.2.5. The position with regard to passenger cars is more complex in that the sums involved could have significant budgetary effects on those Member States (the majority) which do not currently grant any right to deduct. On the other hand, the degree of distortion of competition is more pronounced by virtue of this fact.

4.2.5.1. The situation has been brought more sharply into focus by the recent ruling of the European Court of Justice in the Aro Leasing case, where it was held that the leasing of motor vehicles is a service and does not constitute a supply of goods. Under existing legislation, this means that a taxable person located in one of those Member States which do not grant a right to deduction could lease a passenger car from a company established in one of the three Member States (Germany, Holland and Luxembourg) which do give a right of deduction and could then make an Eighth Directive claim for refund upon the Member State in which the leasing company was established. It would not be necessary for the vehicle to originate or be registered in that Member State or ever to have entered its territory.

4.2.5.2. Clearly, this ruling gives rise to the potential for major distortions of competition although, in practice, the impact may be greater in some Member States than in others. Those Member States which do not currently give a right to deduct stand in considerable danger of substantial loss of revenue and any estimation of the budgetary effects of the Commission proposals on those Member States should be seen in the light of this situation.

4.2.6. The Commission proposals would resolve the Aro Leasing problem and they represent a significant improvement on the subsisting situation for both traders and national administrations but they remain complex and the options granted to the Member States create the potential for residual distortions of competition due to differences in the way in which Member States elect to exercise the options.

4.2.7. However, the Committee welcomes the improvement of the situation brought about by the Commission proposal. Further simplification, e.g. across-the-board application of the 50 % rate, would produce unequal tax treatment on a large scale, as individual groups of citizens would derive a disproportionate benefit from it, whilst government might be deprived of considerable funds.

4.2.8. The Committee would point out that, where an expense is deemed to contain elements of both business and private expenditure and the right to deduct is withheld in respect of the latter, it is inconsistent to require output tax to be levied on that portion of the expenditure, since this would effectively constitute double taxation. This would apply even where a company was reimbursed by an employee for the private element of the expenditure incurred.

4.3. *Verification, refund and administrative cooperation procedures*

4.3.1. The Economic and Social Committee, agrees with the Commission that the present proposals will substantially assist the verification process because the national administrations in each state will be dealing with traders who are registered for VAT in that State and of whom they have some background knowledge. Directive 77/799/EEC on mutual assistance enables the Member States concerned to exchange any information they consider necessary in order to exercise their respective powers of inspection.

4.3.2. However, the Committee notes that past experience has shown that the Member States are not yet making full use of the opportunities provided by the Community instrument and that, as a result, the Commission has felt obliged to provide for additional measures of verification in the interim.

4.3.3. As the Commission acknowledges, these additional measures reduce the simplifying effects of changing the deduction system and are only acceptable in the short term. The Committee welcomes the Commission's assertion that the length of time for which they are applied must be strictly limited to the time required to improve cooperation between the Member States. It notes with approval that the Commission will regularly examine the use of these measures and their practical results for Member States.

4.3.3.1. The Committee urges the Commission to repeal these measures at the earliest possible opportunity and, in order to achieve this, to encourage Member States by all means in its power to improve their levels of cooperation.

5. **Conclusions**

5.1. The Economic and Social Committee welcomes the Commission proposals as representing a fundamental improvement on the position which currently pertains. Businesses and national administrations alike would be relieved of a considerable proportion of the burdens which they presently have to bear and, for many traders, obtaining the refund of tax paid in Member States in which they are not established would at last become a reality.

5.2. For these reasons, the Committee approves the proposal to allow traders to deduct VAT incurred in Member States where they are not established from their periodic returns in those Member States where they are established and to abolish the Eighth Directive procedure. It agrees that this is the only effective way to simplify the present system.

5.2.1. The Committee also broadly approves the proposals concerning expenditure which is not eligible for full deduction.

5.3. The Committee hopes that the period for which the additional verification measures are in force will be curtailed to the greatest possible extent.

5.4. The Committee regards the present proposals as constituting a further important step towards the creation of a true Single Market, in line with its previous recommendation that ongoing reforms to the existing VAT system should continue to be carried out pending the introduction of a new definitive system. Nevertheless, it considers that these measures do no more than tinker with problems that can only be finally resolved by a new common system of VAT. In this context, it calls upon the Member States to adopt a constructive and positive approach to the subject of VAT reform in the interests of European integration and the realization of the Single Market.

5.5. In its Annual Report concerning the financial year 1997 [1], Court of Auditors said of the present transitional VAT arrangements that, 'In spite of the introduction of an a posteriori system of information exchange (VIES), the potential for fraud has thus been increased'. The report went on to say that, 'In the absence of a viable alternative, the current "transitional" system will remain in place for several more years. Substantial improvements appear unlikely in the absence of a clear determination to give priority to fighting fraud in intra-Community trade'. The ESC endorses the position taken by the Court of Auditors and stresses the

[1] OJ C 349, 17.11.1998, pp. 16-17.

need for the Member States to find the political will and determination to agree on a new definitive system of VAT without further delay. It would point to the fact that the present transitional arrangements came into force on 1 January 1993 and were intended to last only until 31 December 1996.

Brussels, 28 January 1999.

The President
of the Economic and Social Committee
Beatrice RANGONI MACHIAVELLI

APPENDIX I

to the opinion of the Economic and Social Committee

In practice, the operation of the Eighth Directive refund procedure poses considerable problems for both traders and the national administrations of the Member States.

First, the procedure has given rise to complaints, from traders, and in particular that:

— administrative formalities are burdensome (requests must be made in an official language of the country of refund, documents must be presented by fixed time limits, etc.). In practice, traders are frequently obliged to employ local advisors to handle them;

— more and more Member States are failing to respect the time limits for refunds laid down by the Directive. Thus traders are compelled to pay the tax in advance and shoulder the cost over long periods this can represent a considerable financial burden. Uncertainty as to when the refund will be made and, consequently, as to the size of financial burden to be borne creates uncertainty for traders as to the costs to pass on to their customers;

— national administrations apply the provisions of the Eighth Directive extremely literally and rigidly, so that requests are frequently rejected on technicalities and traders are given the impression that national administrations wish to discourage the use of the refund procedure.

The burden and the cost of administrative formalities, together with the extended period for refund payments, mean that taxable persons who are entitled to a refund of VAT are discouraged from exercising that right. As a result, the practical difficulties which taxable persons encounter in making a claim undermine the very principle of the deductibility of the tax and its intended neutrality irrespective of the Member State of supply.

On the other hand, the refund procedure creates considerable problems for the competent national administrations, since it has proved more difficult that expected to operate. Each refund request involves a physical intervention by the administration of the Member State of refund. The Member States must consequently allocate a significant number of officers to the completion of tasks deemed to be unproductive, the purpose of which is to refund a tax collected on the national territory to taxable persons from other countries. Even more important is the lack of effective verification as to whether applications for refund, and the amounts to be refunded, are justified. The information available allows the Member State to verify only:

— the applicants' status as taxable persons (on the basis of certification by the Member States in which they are established);

— the conformity of the invoices or import documents;

— the correct application of the limits to the right to deduct which are in force in the Member State of refund.

However, the Member State of refund has no information as to how the expenditure is actually divided between activities which are taxed, exempt or outside the scope of VAT or as to how the right to deduct is exercised (according to the proportion deductible or actual attribution). Thus, the Member State is unable to take account of the taxable person's overall tax situation and is obliged to take decisions on the basis of incomplete information.

The Member States are well aware of this situation; in 1993, the complexity and cost of the procedure led eleven of the then twelve Member States to ask for a derogation on the basis of Article 27 which would enable them to introduce special measures for taxing certain work on moving, tangible property located in the territory of the country but directly related to the intra-EU transport of goods, so that traders would not have to use the Eighth Directive as a matter of course.

These derogations, authorized by Council Decisions, were justified by the fact that the increasing use of the refund procedures could impede the development of intra-Community trade in certain services.

The Council also amended the fifteen Commission proposals for a Decision on special measures for the taxation of telecommunications services, with a view to simplifying collection of the tax, so that operators did not have to use the Eighth Directive procedure.

In view of these problems, it was not unexpected for the SLIM Initiative to make a recommendation on the Eighth Directive refund procedure, which was supported by representatives both of national administrations and the business community.

It should be stressed that these difficulties will be definitively resolved by the introduction of the new common system of VAT, as set out in the work programme adopted by the Commission in July 1996.

Under this new system, based on the principle of taxation in the country of origin and on a single place of taxation and deduction, every taxable person would be able to deduct the VAT in one place, even if the transaction were taxed in another Member State. Consequently, the Eighth Directive procedure would become redundant.

The Commission has, however, decided to react promptly to the SLIM recommendations, while bearing in mind that any legislative initiative in this area can only be of a temporary nature, pending the entry into force of the new common system of VAT.

The objective of the present proposal is therefore to improve the operation of the existing system of VAT in the short term by simplifying a procedure which, in the view of the business community, impedes the operation of the Single Market, while not undermining the continuation of the work envisaged by the work programme for the new common system.

Consequently, certain parts of the present proposal will be revised as and when proposals for the introduction of the future system are presented.

The Commission is proposing additional verification measures, the justification and need for which will be regularly reviewed, with the sole object of immediately permitting adequate monitoring of the deduction on the absence of satisfactory cooperation between Member States in the area of verification.

Another consequence is that, were the Council not to adopt the present proposal within a reasonable period, the Commission would feel obliged to withdraw it, so that the Council did not have to go on discussing a proposal which could not achieve its objective and which, if adopted belatedly, could jeopardize the transition to the new common system.

The Commission takes the view that the only change which can, in fact, significantly simplify the common system of VAT in general, and the refund procedure in particular, is to authorize taxable persons to deduct the VAT paid in a Member State where they are not established, by setting it off in their periodic returns against the amount of VAT for which they are liable in a Member State where they carry out taxable transactions, for which the VAT-bearing goods or services are used.

The purpose of this present proposal is to introduce this right to deduct into Article 17 of the Sixth Directive, with the result that the special refund procedure for taxable persons established in the EU (i.e., the procedure laid down in the Eighth Directive) will disappear.

In substance, the proposed measures, which take the legal form of an amendment to paragraph 3 and the inclusion of paragraph 3a in Article 17, achieve the following result, as regards taxable persons established in the European Community:

— the taxable person is identified in a single Member State: the VAT is deducted in that Member State, irrespective of the Member State where he incurred the VAT-bearing expenditure;

— the taxable person is identified in several Member States:

a) he is identified in the Member State where he has incurred the VAT-bearing expenditure:

the VAT is deducted in that Member State (no change as compared with the present situation).

b) he is not identified in the Member State where he has incurred the VAT-bearing expenditure:

the VAT is deducted in the Member State where he supplies goods or services for which the expenditure is used.

It follows logically from this amendment of Article 17 that the amount of VAT eligible for deduction will now be determined according to the rules of the Member State of establishment, and no longer according to the rules of the Member State which collected the tax, as is the case at present.

In terms of formalities, this proposal requires taxable persons to present a specific document, to be attached to their periodic return, on which they enter the VAT amounts paid in other Member States for which they are exercising their right to deduct. These amounts are to be broken down by Member State. A copy of the invoices or import documents is to be attached to this specific document in order to provide proof.

APPENDIX II

to the opinion of the Economic and Social Committee

As regards the rules for the deduction of VAT, Article 17(6) of the Sixth Directive states that:

'Before a period of four years at the latest has elapsed from the date of entry into force of this Directive, the Council, acting unanimously on a proposal from the Commission, shall decide what expenditure shall not be eligible for a deduction of value added tax. Value added tax shall in no circumstances be deductible on expenditure that is not strictly business expenditure, such as that on luxuries, amusements or entertainment.

Until the above rules come into force, Member States may retain all the exclusions provided for under their national laws when this Directive comes into force.'

Proposals submitted by the Commission failed to find a consensus in the Council and were finally withdrawn on 21 November 1996 as a logical consequence of the Commission's adoption in July 1996 of the work programme for the introduction of a new common system of VAT.

In the meantime, Member States have approached the issue in different ways. Three of them (Germany, Holland and Luxembourg) grant the right to full deduction in accordance with Article 17(2) for the expenditure in question, or for the most important categories of such expenditure, the only exclusion being that which has no business characteristic. The remainder exclude or limit the right to deduct so as to eliminate or substantially simplify cases where a distinction has to be made between expenditure relating to the private needs of the taxable person and others, and expenditure connected with the economic activities of the taxable person.

This situation does not meet the essential requirements of uniformity of the basis of assessment and tax neutrality.

The taxable persons of a Member State which authorizes full deduction of the tax for all expenditure except that which has no business characteristics enjoy an advantage over taxable persons of a Member State where some categories of expenditure are excluded from the right to deduct. This can lead to distortions of competition in international trade in goods and services, in so far as its effects are reflected in the price.

Although the existence of this diverse treatment is not a new problem, the establishment of the Internal Market on 1 January 1993 highlighted these differences far more sharply by bringing national laws, and the way they are applied in the Member States, into more direct juxtaposition.

The Commission therefore feels it necessary to act on the mandate conferred upon it by Article 17(6) of the Sixth Directive and to resume the approximation of the different national rules which exist at present, while leaving Member States some margin of discretion to take account of their specific situations.

It should not be forgotten that the right to deduct is a basic feature of the VAT system; consequently, any exclusion from this right is an exception to the rule and is unacceptable unless it is specifically justified.

Clearly, therefore, it must be confined to categories of expenditure which, even when incurred as part of the normal running of a business, usually contains some element of the final and private consumption. In general, moreover, it should apply to situations where there can be no real verification of how such expenditure is apportioned between the business and private elements, so that risks of abuse or tax fraud are created.

Typically, such expenditure is that relating to passenger cars, expenditure on accommodation, food and drink, and expenditure on luxuries, amusements or entertainment.

Expenditure on passenger cars must be considered to refer to capital goods, the non-business use of which cannot be ruled out and which, above all, may change from year to year.

Although expenditure on accommodation, food and drink can be incurred because of the business activity, exercised, it can also be said to have private characteristics, since it is expenditure which satisfies primary needs.

It should be borne in mind that the basic principle that the tax charged on goods and services used for the purposes of taxed transactions is deductible means that the deduction cannot apply to expenditure which is not of a strictly business nature, such as expenditure on luxuries, amusements or entertainment, in accordance with the present version of Article 17(6).

The Commission proposal incorporates various systems to take account of the specific nature of such expenditure as part of the activity of taxable persons.

In general, the normal deduction rules would apply to the VAT on expenditure relating to passenger cars. However, if difficulties in verifying the non-business use of these goods were so great that they prevented a Member State from applying the normal deduction rules in practice, an optional system for limiting the deduction would be established, enabling Member States which so wished to measure the non-business use of passenger cars in a simplified fashion.

A Member State which made use of this option could set a maximum percentage for deduction which might not be lower than 50 % of the input tax, this amount corresponding to the maximum business use which, it is assumed, would have been or would be made of the passenger cars.

By utilizing this option, the administration would not need to monitor the way in which a substantial majority of taxable persons apportioned the private and business usage of their passenger cars in their accounts.

However, where the percentage of business use was not as high as the percentage of the ceiling for deductible VAT set by the Member State of the deduction, the deduction would be made according to the normal rules.

Application of a maximum deductible percentage enables a simplified distinction to be drawn between the input tax which is:

a) related to the non-business use of cars (i.e. private use but also use linked to transactions outside the scope of VAT); and,

b) related to the business use of cars i.e., for transactions within the scope of VAT, both transactions in respect of which VAT is deductible and exempt transactions where VAT is not deductible.

Consequently, where the taxable person carried out both transactions in respect of which VAT was deductible and transactions in respect of which VAT was not deductible, the proportion of input VAT relating to the business use of passenger cars would still have to be analyzed in order to determine the VAT attributable to the former and latter transactions.

However, when the business use of the goods in question was negligible, the time spent by the administrations on the verification process would not be commensurate with the results. That is why the present proposal provides for total exclusion from the right to deduct where the business use is less than 10 %.

Special consideration is given to taxable persons whose business activity consists in the operation of passenger cars or who rely on such goods to engage in their activity (e.g. taxable persons whose economic activity consists of the sale, hire, renting or leasing of passenger cars or who operate taxis, driving schools etc.). In this case, the normal deduction rules are applied, but only if any non-business use is negligible (i.e. less than 10 %).

As regards expenditure on accommodation, food and drink, the Commission feels that their characteristic of final consumption may justify their exclusion from the right to deduct. However, such expenditure may be caused by the needs of the business activity (e.g. because it is incurred in the course of business travel). Therefore, a flat-rate limit on the deduction is considered fair, with the flat-rate percentage for deduction being set at 50 % of the VAT charged on expenditure on accommodation, food and drink.

However, deduction would continue to be completely ruled out for expenditure that is not directly and strictly linked to the needs of the taxed transactions (i.e. expenditure on luxuries, amusements and entertainment).

APPENDIX III

to the opinion of the Economic and Social Committee

A bilateral refund and compensation system for debts

This document contains the information required to operate a refund system between the Member States, so that the Member State in which the deduction is made (Member State of deduction) can obtain a refund thereof from the Member State where it was paid (Member State of purchase). The attached proposal for a Regulation deals with this debt refund and compensation system, and with the verification measures to be established by the Member States.

The proposal for a Regulation provides for the introduction of a debt compensation and refund system which operates bilaterally between the Member States. For this purpose, each Member State will, every six months, inform each of the other Member States of the amount of VAT deducted during the past half year which the Member State of purchase is required to refund.

The amount to be notified represents the amount of VAT actually deducted, i.e. after application of the proportion when the taxable person is engaged both in activities in respect of which VAT is deductible and activities in respect of which VAT is not deductible, and after the limits on the right to deduct which are in force in the Member State of deduction have been applied.

In this way, any Member State can establish the balance payable to or receivable from the other Member States. These balances are actually paid at a later date, because they may still be adjusted as a result of the verifications laid down by the Regulation. However, there is provision for the Member States, by bilateral agreements, to derogate from the deadline laid down by the Regulation by setting other deadlines or, in certain circumstances, by allowing the balance to be carried over until the following period.

Verification measures

Under the present VAT system, each Member State is responsible for applying, monitoring and collecting the tax, which goes directly into its national budget. One of the basic principles of this system is that the VAT is deducted in the Member State where the tax was due and/or paid. A single Member State is therefore responsible for verifying payment and deducting the tax.

The purpose of the present proposal is to introduce a derogation from the above principle for the cases today covered by the Eighth Directive.

As a result, for the transactions concerned, the Member State of purchase will be responsible for verifying that the VAT has been paid, whereas the Member State of deduction will be responsible for monitoring the deduction of that tax.

Like any other verification, this should be based on the knowledge which the tax administrations have of their taxable persons, on how their reliability is assessed, the fraud risk that these taxable persons represent and on thorough and efficient cooperation with the administrations of the other Member States. Effective control in the Internal Market requires the establishment of common criteria for assessing the fraud risk that a taxable person represents, rather than the routine forwarding of copies of invoices which constitutes an additional burden for both taxable persons and administrations. The cases which, on the basis of these common criteria, are identified as requiring more thorough monitoring, would be of interest to all the administrations concerned. This would enable them, as a result of their mutual interest in effective cooperation, to exploit to the full the information and experience they possess.

Directive 77/799/EEC on mutual assistance enables the Member States concerned to exchange any information they consider necessary in order to exercise their respective powers of inspection. Past experience demonstrates, however, that the Member States are not yet making full use of the opportunities provided by this Community instrument.

In view of this experience, and of the special nature of the proposed system, which seeks to improve the operation of the present VAT system, the Commission is obliged to provide for additional verification measures to accompany its introduction.

These additional measures reduce the simplifying effects of changing the deduction system and are only acceptable in the short term. The length of time for which they are applied must be strictly limited to the time required to improve cooperation between the Member States.

The Commission will regularly examine the use of these measures and their practical results for the Member States. For this purpose, the Member States are required to provide the Commission with the necessary information. The Commission will present to the Council, by the end of the second year in which these measures are applied, a report on whether they are justified and necessary as part of its monitoring of the cooperation between the Member States on verification, where necessary accompanied by proposals repealing the said measures.

As regards the verification measures laid down by the present proposal, it is important to bear in mind the nature of most of the expenditure for which refund requests are now made under the Eighth Directive procedure.

Because of the rules for the location of transactions, most of these requests relate to general costs, such as hotel and restaurant costs, costs connected with taking part in fairs and the vehicle and motor fuel costs of international road transport operators.

It is therefore unlikely that the proposed system, under which these amounts will be set off against the tax owed by the taxable person, will substantially increase the situations in which operators are entitled to high tax credits, which usually require more monitoring by the administration.

Consequently, it is necessary to ensure that the verification measures proposed specifically for operating the deduction system are not disproportionate to the risks of tax losses for the Member States.

The measures provided for by the Regulation result in several-stage verification and for each of the stages establish the financial responsibilities of the Member States concerned.

This phased verification has a great advantage over the present system, since it does not require the administration to take an 'immediate and virtually final' decision, as it the case today.

First, the administration of the Member State of deduction carries out an initial verification when it receives the periodic return, the specific document and its annexes. Unlike the administration of the Member State of refund under the present system, the competent administration will already possess more precise data concerning the tax situation of the taxable person.

Clearly, the amount corresponding to the adjustments that are necessary following this initial verification is not included in the amount of VAT which the Member State of deduction requires the Member State of purchase to refund.

Next, the Member State of deduction provides the Member State of purchase with information, normally in electronic form, concerning certain transactions for which a deduction under Article 17(3a) is made.

When the Member State of purchase detects irregularities relating to the transactions for which the deduction has been made, it must inform the Member State of deduction thereof within three months of receiving the information. In addition, the Member State of purchase is not required to refund the amount of VAT in question to the Member State of deduction.

It is up to the Member State of deduction to take the recovery measures it considers appropriate, particularly in the light of the tax situation of the taxable person in question (filing of periodic returns, payment of the tax due, other existing tax debts).

In addition, irrespective of the place where the VAT was paid, the Member State of deduction examines whether the deduction made is justified, as part of the scheduled inspection of all the taxable person's activities.

Lastly, under the verification procedure laid down by this proposal there is nothing to prevent the administrations from requesting information by utilizing the mutual assistance Directive procedure.

Also, the Commission is well aware of the fact that the non-harmonization of information that has to appear on invoices is liable to pose problems. However, this problem already exists in normal intra-Community trade (supplies/intra-Community acquisitions, intra-Community transport, etc.) the only difference being, in the present case, that VAT is actually invoiced in the Member State of purchase. The SLIM report also contains a recommendation to study this problem. The Commission will not fail to act on this recommendation.

Pending the outcome of such work, the operation of the proposed system requires a minimum of flexibility from the Member States. They have to ensure that a taxable person in possession of an invoice, which mentions at least the information required by the Sixth Directive, is not prevented from exercising his right to deduct.

Nevertheless, an administration has the right to request from the taxable person a translation of the invoice entries in cases where it is unable to assess the business nature of the expenditure.

APPENDIX IV

to the opinion of the Economic and Social Committee

(In accordance with Rules 47 (3) of the Rules of Procedure)

The following amendments, which received at least one quarter of the votes cast, were defeated during the discussion:

Amendment tabled by Mr Tosh and Mrs Williams

Point 4.2.4

Replace by the following:

'4.2.4. The Committee believes that entertainment expenditure should be treated in the same way as expenditure on accommodation, food and drink rather than being equated with luxury expenditure.'

Reason

Entertainment expenditure is a legitimate business expense since the primary purpose of corporate entertaining is to secure or increase business. While there is an element of private consumption, this places it in the same category as expenditure on accommodation, food and drink. It should not be treated in the same way as luxury expenditure which, by definition has no appreciable benefit for the business.

Result of the vote

Against: 51, for: 25, abstentions: 4.

Amendment tabled by Mr Lustenhouwer and Mr Regaldo

Point 4.2.7

Replace by the following:

'4.2.6.1. The Economic and Social Committee sees no compelling reason why passenger cars should not be subject to the same flat-rate deduction as the other categories of expenditure dealt with in these proposals and believes that this would make an important contribution to reducing the distortion of competition and restricting the scope for fraud and legitimate manipulation.

4.2.6.2. Wide disparities between the rates of deduction permitted in different Member States would place traders operating in those countries with low rates of deduction at a competitive disadvantage with traders established in countries with higher rates of deduction and this would inevitably lead to the development of complex systems for circumventing the rules, legally or otherwise.

4.2.6.3. Moreover, it should be borne in mind that VAT becomes payable when a car is first purchased and at that point it is not possible to determine with any degree of accuracy what the ratio of business to private use may be throughout its working life. This could vary from year to year and, in the absence of a single flat-rate, that would give rise to the need for retrospective adjustments, thereby creating additional complications for traders and national administrations alike.

4.2.6.4. A flat-rate would also introduce a desirable measure of simplicity into the situation. For instance, it would no longer be necessary for traders to keep records of, or for administrations to verify, the percentage of business use or to distinguish between business use relating to taxable and non-taxable transactions.

4.2.6.5. The Economic and Social Committee would point out that, if the object of the exercise is to simplify (and that is one of the Commission's declared aims), then the procedures should be made as simple as possible and it does not seem that this has been achieved by the present proposals. Where a Member State exercises the option, it will still be necessary to verify at least approximately the percentage of business mileage and it may be necessary to make retrospective adjustments. This will impose additional work on both national administrations and traders, while creating an element of uncertainty for the latter.

4.2.7. Logically, there seems to be no reason why other forms of private transport, such as aeroplanes and helicopters, should not be brought within the scope of these regulations.'

Reason

The present text was incorporated in the draft opinion as a result of an amendment approved by a majority vote at the section meeting. As a result of this vote, the present point 4.2.7 replaces six paragraphs drafted by the rapporteur.

The aim of this amendment is to restore the rapporteur's original text because the present version does not tally with the Commission proposals and would produce an incomprehensible opinion (on this point).

Result of the vote

Against: 56, for: 39, abstentions: 8.