



# Special scheme for small and medium-sized enterprises in the EU

## A useful tool for European businesses or a risk for abusive practices

written by

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## Abbreviations

AG – Advocate General

CoJ – Court of Justice of the EU

ECU – European Currency Units

EU – European Union

SBA - “Small Businesses Act”

SME – Small and Medium-sized enterprises

TEC – Treaty establishing the European Community

TEU – Treaty on European Union

TFEU – Treaty on Functioning of the European Union

TVA – Tax on Value Added

VAT – Value Added Tax

# 1. Introduction

## 1.1 Background

The system of value-added tax in the European Union is a general system that covers all stages of production and distribution and the provision of services and is also applied in the retail stage.<sup>1</sup> Art. 2 of the First Council Directive<sup>2</sup> stipulates that a general tax on consumption shall be applied to the price of goods and services regardless the number of transactions prior the stage at which the tax is charged. This system shall be applied also up to and including the retail trade stage.

In fact, there are provisions in the VAT Directive that derogates from this general system of VAT. These provisions are the so-called special schemes. They can be found in title XII *Special Schemes* of the VAT Directive. Alongside with the special schemes for farmers, travel agents, second-hand goods, investment gold and non-established taxable persons supplying electronic services to non-taxable persons we also can find special scheme for small enterprises. The arrangements regarding the special scheme for small and medium-sized enterprises (SME) can be found in Chapter 1 *Special schemes for small enterprises*, namely from art. 281 to art. 294 inclusively. In accordance to the provisions in Chapter 1 the simplified scheme can be: an exemption from VAT, flat-rate scheme or graduated system.

Undertakings using the flat-rate scheme are allowed to pay VAT at a certain percentage of their turnover in accordance with their business activities. These undertakings are exempted to charge and reclaim VAT on every transaction.

Under a graduated tax relief system an undertaking might be allowed to pay no VAT up to a specific threshold above which the percentage of VAT starts increasing up to a moment when all the VAT is paid and no relief is given.

The system with exemption from VAT is the most widely used one in the European Union for small and medium-sized enterprises.<sup>3</sup> Under the arrangements of this scheme an undertaking which has a turnover below a threshold, set by every Member State, are exempt from VAT. Businesses using this exemption scheme are not allowed for VAT deduction.

## 1.2 Purpose

The purpose of this paper is to analyze the current, previous and proposed provisions regarding the special scheme for small and medium-sized enterprises in the VAT Directives. The aim of this analysis is to extract the main characteristics of the scheme. Once the main characteristics are clear it will be tested whether this scheme is beneficial for the businesses and the state revenue. The third task of the paper will be to check if there is a risk for abusive practices.

## 1.3. Problems

There will be three problems discussed in the paper. These problems are are as follows:

1. Current legal framework regarding the special scheme for small and medium-sized enterprises and its historical development.
2. Benefits for the businesses and the Member States from the adoption of the scheme.
3. Risk from abusive practices.

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<sup>1</sup> First Council Directive 67/227/EEC, fifth recital

<sup>2</sup> Id, art. 2

<sup>3</sup> SEC(2010) 1455, pp. 78

## 1.4 Method and materials

To achieve the purposes of this paper the author will divide the essay in three parts.

In the first part he will examine the provisions regarding the special scheme in the VAT Directive and will make a retrospection of the scheme starting from the Second VAT Directive and passing through the Sixth Directive and the two proposals for introduction of a common threshold. He will also try to find other provisions in the VAT Directive related to SME. The end of this part will consist of proposals for the future of the scheme and the main aims of the scheme.

In the second part, once the main purposes of the scheme are clear, the author will try to check whether this scheme is beneficial for the small-scale businesses and the Member States. The author will examine the different scenarios a SME under the exemption scheme may face. He will also check whether the scheme can be used by undertaking trading in the European Union.

In the third part it will be examined whether there are risks from abusive practices. In order to comply with this task the author will analyze Schmelz case and joint case Direct Cosmetics Ltd. and Laughtons Photographs Ltd.

## 1.5 Delimitation

This essay will mainly focus on the special scheme for small and medium-sized enterprises in the European Union. This is the reason why arrangements regarding SME schemes in other countries will not be examined. With regard to the abusive practices – only those situations covered by Schmelz case and Direct Cosmetic Ltd. and Laughton Photographers Ltd. will be included in the paper.

## 2. Special scheme for small and medium-sized enterprises

### 2.1 The special scheme at present

In Section 1 *Simplified procedures for charging and collection* there is only art. 281. According to this article it is possible for Member States, which face difficulties to apply the normal VAT provisions to small businesses, to provide simplified provisions for charging and collecting VAT. In order for these arrangements to be provided the VAT Committee has to be consulted first.

The rules regarding the implementation of exemption from VAT without a right for deduction and graduate tax relief can be found in Section 2 *Exemptions or graduated relief*. First of all in art. 282 it is clarified that both exemptions from VAT and graduated relief can be applied to the supply of goods and services only by small enterprises. After this there are limitations to the provisions provided in this Section. According to art. 283 the provisions provided in Section 2 shall not apply to the transactions as follows:

- transactions carried out on an occasional basis, as referred to in art. 12;<sup>4</sup>
- supplies of new means of transport carried out in accordance with the conditions specified in art. 138(1) and (2)(a);<sup>5</sup>
- supplies of goods or services carried out by a taxable person who is not established in the Member State in which the VAT is due.<sup>6</sup>

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4 Council Directive 2006/112/EC, art. 283(1)(a)

5 Id, art. 283(1)(b)

6 Id, art. 283(1)(c)

This article also provides the opportunity for the Member States to exclude other transactions than those referred above.

Further in the provisions in this section the rules covering the turnover threshold are provided. They can be found in art. 284 to art. 288 inclusively. In art. 284(1) it is stated that Member States that have exercised the option provided in art. 14 of the Second VAT Directive<sup>7</sup> can keep the rules regarding exemptions and graduate tax relief together with the arrangements for applying them. But only if they comply with the VAT rules. According to art. 284(2) Member States which exempted taxable persons with an annual turnover of 5,000 European units of account by 17 May 1977, may raise the threshold up to 5,000 EUR. Member States providing the graduate tax relief cannot raise the ceiling and cannot render more favorable conditions for granting it either. For Member States that have not exercised their right provided in art. 14 of the Second VAT Directive an opportunity to exempt taxable persons with a turnover of less than 5,000 EUR or the equivalent in national currency is provided in art. 285. Member States can also grant graduated tax relief to taxable persons which exceed the above mentioned threshold. In accordance with art. 286 The Member States which, at 17 May 1977, had an exemption for taxable persons with a turnover equivalent or higher than 5,000 European units of account converted in national currency “may raise the ceiling in order to maintain the value of the exemption in real terms”<sup>8</sup>. Art. 287(1-18)<sup>9</sup> specifies the turnover threshold for the Member States entered the Union after 1 January 1978.<sup>10</sup>

The rules defining the turnover are provided in art. 288. It stipulates that the turnover used for applying the arrangements concerning the exemption from VAT should consist of the following amounts, exclusive of VAT:

- the value of supplies of goods and services, in so far as they are taxed;<sup>11</sup>
- the value of transactions which are exempt, with deductibility of the VAT paid at the preceding stage, pursuant to Articles 110 or 111, Article 125(1), Article 127 or Article 128(1);<sup>12</sup>
- the value of transactions which are exempt pursuant to Articles 146 to 149 and Articles 151, 152 or 153;<sup>13</sup>
- the value of real estate transactions, financial transactions as referred to in points (b) to (g) of Article 135(1), and insurance services, unless those transactions are ancillary transactions.<sup>14</sup>

It also clarifies that the disposals of both tangible and intangible capital assets shall not be taken in consideration in calculating the turnover.

Art. 289 precludes the entities benefiting from the special scheme from the right of deduction of VAT in accordance with art. 167 to 171 and art. 173 to 177. They also cannot show VAT on their invoices. Following art. 290 all the persons eligible for exemption from VAT can either opt for normal VAT arrangements or simplified procedures as they are provided in art. 281. In such case they should be entitled for a graduated tax relief, if there is one provided in the national legislation. Art. 291 states that taxable persons enjoying graduated relief should be regarded as normal taxable persons subject to the normal VAT rules. The last article from Section 2, namely art. 292, sets the

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7 Second Council Directive 67/228/EEC

8 Council Directive 2006/112/EC, art. 286

9 (17) and (18) are valid from 1 January 2011 based on Directive 2009/162/EU

10 1 January 1980 – Greece, 1 January 1986 – Spain and Portugal, 1 January 1995 – Sweden, Austria and Finland, 1 May 2004 - Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia, 1 January 2007 – Bulgaria and Romania

11 Council Directive 2006/112/EC, art. 288(1)

12 Id, art. 288(2)

13 Id, art. 288(3)

14 Id, art. 288(4)

time limit for the provisions provided in the section. All the rules provided in this section shall apply until a date which has to be chosen by the Council in accordance with art. 93 of the Treaty.<sup>15</sup> This date cannot be later than the date on which the definitive arrangements, set in art. 402 of the VAT Directive, will take effect.

In Section 3 *Reporting and review* there are two articles which deal with the reporting and review of the rules provided in Chapter 1 *Special scheme for small enterprises*. Every four years after the adoption of the VAT Directive, the Commission should present to the Council a report regarding the application of Chapter 1. The information for this report should be obtained from the Member States. It also has to include proposals on the following issues:

- improvements to the special scheme for small enterprises;<sup>16</sup>
- the adaptation of national systems as regards exemptions and graduated tax relief;<sup>17</sup>
- the adaptation of the ceilings provided for in Section 2.<sup>18</sup>

The last article regarding the arrangements for small and medium-sized enterprises is art. 294. It enacts that it is a responsibility of the Council to decide, in accordance with art. 93 of the Treaty<sup>19</sup> whether the special scheme for SME is necessary under the definitive arrangements. It also has to define the common limits and conditions for implementation of this scheme.

## 2.2. Other provisions regarding small and medium-sized enterprises

The VAT directive contains other provisions, except those in Title XII *Special schemes*, regarding the SME. Looking in the Directive these arrangements can be found from the very beginning.

The first provision related to SME is found in art. 2. This article enacts all the transactions which shall be subject to VAT. According to art. 2(b) subject to VAT is an intra-Community acquisition for consideration within the territory of a Member State by:

- a taxable person acting as such or a non-taxable legal person, if the vendor is a taxable person acting as such, not covered by the exemption for SME provided for in art. 282 to 292, or covered by articles 33 or 36.<sup>20</sup>
- for new means of transport, a taxable person or a non-taxable legal person, whose other acquisitions are not subject to VAT covered by art. 3(1), or any other non-taxable persons.<sup>21</sup>
- for products subject to excise duty according to Directive 92/12/EEC, a taxable person or a non-taxable legal person, whose other acquisitions are not subject to VAT covered by art. 3(1).<sup>22</sup>

Art. 3(1) by way of derogation from art. 2(b)(i) stipulates that intra-Community acquisition of goods, other than new means of transport or products, subject to excise duty, by “a taxable person who carries out only supplies of goods or services in respect of which VAT is not deductible”.<sup>23</sup> Paragraph 2 of this article sets a threshold for benefiting from the provisions set in art. 3(1)(b). It states that these provisions are valid only if the total value of intra-Community acquisitions during

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15 Art. 93 of the TEC, now art. 113 of the TFEU

16 Council Directive 2006/112/EC, art. 293(1)

17 Id, art. 293(2)

18 Id, art. 293(3)

19 Art. 93 of the TEC, now art. 113 of the TFEU

20 Council Directive 2006/112/EC, art. 2(b)(i)

21 Id, art. 2(b)(ii)

22 Id, art. 2(b)(iii)

23 Id, art. 3(1)(b)

the current calendar year does not exceed a threshold set by every Member State.<sup>24</sup> This threshold cannot be less than 10,000 EUR or the equivalent in national currency.<sup>25</sup> This threshold should not be exceeded by the total value of intra-Community acquisitions during the previous calendar year.<sup>26</sup> In accordance with paragraph 3 the taxable persons and non-taxable legal persons eligible under art. 3(1)(b) shall be granted the opportunity to opt for the normal scheme provided for in art. 2(1)(b)(i).

The next provisions relating to SME are art. 33 and art. 34 of the VAT Directive. According with art. 34 by way of derogation from art.32 the place of supply of goods dispatched or transported by the supplier or on his behalf from a Member State different from the one in which the transport ends should be deemed to be the place where the transport of the goods to the client ends. This is valid under the following conditions:

- the supply of goods is carried out by a taxable person or a non-taxable legal person , whose intra-Community acquisitions of goods are not subject to VAT pursuant to art. 3(1) or for any other non-taxable person.<sup>27</sup>
- the goods are neither new means of transport nor goods supplied after assembly or installation, with or without trial run, by or on behalf of the supplier.<sup>28</sup>

On the other hand, art. 34 provides conditions under which the provisions set in art. 33 are not valid. The following criteria regarding the transported goods should be fulfilled:

- they are not subject to excise duty.<sup>29</sup>
- the total value, without VAT, for supplies according to the provisions in art.33, shall not exceed in any one calendar year 100,000 EUR or the equivalent in national currency.<sup>30</sup>
- the supplies of goods, other than goods subject to excise duty do not exceed the same threshold during the previous calendar year.<sup>31</sup>

Paragraph 2 gives the opportunity to the Member States on which territory the dispatch or transport to the customer ends to limit the threshold from 100,000 EUR to 35,000 EUR or the equivalent in national currency. This can be done when a Member State has fears that a threshold of 100,000 EUR could cause serious distortion of competition. A Member State which exercises this right should inform the competent public authorities of the Member State where the transport or dispatch begins.

Paragraph 4 obligates the Member States on which territory the transport or dispatch ends to give the taxable persons eligible under paragraph 1 the opportunity to opt for the place of supply to be determined according to art.33.

Provisions regarding the SME can also be found in Title IX *Exemptions*, Chapter 4 *Exemptions for intra-Community transactions*. According to art. 138(1) Member States shall exempt the supply of goods transported or dispatched to a place outside their territory, but within the Community, by or on behalf of the vendor or the costumer, for another taxable person or a non-taxable person acting as such in a Member State different form the one in which the transport began. Paragraph 2 adds the following transactions which also have to be exempted by the Member States:

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24 Council Directive 2006/112/EC, art. 3(2)(a)

25 For thresholds set by the Member States please see Appendix 1

26 Council Directive 2006/112/EC, art. 3(2)(b)

27 Id, art. 33(1)(a)

28 Id, art. 33(1)(b)

29 Id, art. 34(1)(a)

30 Id, art. 34(1)(b)

31 Id, art. 34(1)(c)

- the supply of new means of transport for taxable persons or non-taxable persons, whose intra-Community acquisition of goods are not subject to VAT according to art. 3(1), or any other non-taxable persons<sup>32</sup>
- the supply of products subject to excise duty to taxable persons or non-taxable persons whose acquisition of goods other than products subject to excise duty are not subject to VAT according to art. 3(1), where those products have been dispatched or transported in accordance with art. 7(4) and (5) or art. 16 of Directive 92/12/EEC

Art. 139 precludes the application of art. 138(1) to the supply of goods carried out by taxable persons who are covered by the exemption from SME provided in art. 282 to 292. The above mentioned exemption shall also not be granted to the supply of goods to taxable persons or non-taxable legal persons whose intra-Community acquisition of goods are not subject to VAT according to art. 3(1). Paragraph 2 clarifies that the exemption provided under art. 138(2)(b) cannot be granted to taxable persons covered by the exemption scheme for SME according to art. 282 to 292.

## 2.3. Historical development of the scheme for small and medium-sized enterprises

The special scheme for SME undergoes a lot of changes before it has the structure at present.

### 2.3.1 The Second VAT Directive

From historical point of view the special scheme for small and medium-sized enterprises is adopted for the first time in the Second VAT Directive.

In art. 99 of the Treaty of Rome<sup>33</sup> the following can be seen:

*The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee adopt provisions for the harmonization of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonization is necessary to ensure the establishment and the functioning of the internal market within the time-limit laid down in Article 7a.*

In 1960, the Commission, in answer of art. 99 of the Treaty, charges a specially created working group with the task of researching the possibilities of harmonizing the existing turnover taxes in the EEC. The working group is divided on three sub-groups: A, B and C. All of them composed of experts from both the Member States and the Commission.<sup>34</sup> The results of this working group are published in the so-called ABC Report.<sup>35</sup> Besides this report the Commission also appoints the Fiscal and Financial Committee to make a report showing the extend to which the existing tax systems among the Member States conflicted with the establishment of a future common market.<sup>36</sup> Both the ABC report and the report done by the Fiscal and Financial Committee, also known as Neumark Report, named after Prof Fritz Neumark from Germany<sup>37</sup>, recommend that a value added tax has to be adopted on the place of the cascade taxes existing at that time.<sup>38</sup>

The Commission agrees with the findings in both ABC and Neumark reports and on 5 November 1962 makes a first proposal for a Directive regarding the harmonization of the turnover tax

<sup>32</sup> Council Directive 2006/112/EC, art. 138(2)(a)

<sup>33</sup> Art. 99 of the Treaty of Rome, then renumbered to art. 93 of the TEC, now art. 113 of the TFEU

<sup>34</sup> Terra, Ben, Kajus, Julie; *A guide to the European VAT Directives vol.1, Introduction to European VAT 2010*, p.285

<sup>35</sup> The EEC Reports on Tax Harmonization. An unofficial translation prepared by Dr M. Thurston, IBFD 1963, p. 1-93

<sup>36</sup> Id, p. 94-157

<sup>37</sup> Terra, Ben, Kajus, Julie; *A guide to the European VAT Directives vol.1, Introduction to European VAT 2010*, p.286

<sup>38</sup> The EEC Reports on Tax Harmonization. An unofficial translation prepared by Dr M. Thurston, IBFD 1963, p. 73 and 154

legislation in the Member States. According to this proposal the harmonization should consist of three stages.<sup>39</sup>

- Four years after the implementation of this Directive, all the Member States should change their existing multistage cumulative turnover taxes to non-cumulative system of their choice
- By 31 December 1969, all these non-cumulative systems should be turned to a common value added tax system
- Abolition of intra-Community tax frontiers. No time limits are set for this stage

On 12 June 1964, an amended version of this proposal is submitted to the Council. In this version of the proposal there are only two stages left:<sup>40</sup>

- Current systems should be changed to a common system of taxation on value added (TVA). Legislation that enables such a system should be adopted by national parliaments before 31 December 1967. However, the entry into force may be postponed until 31 December 1969
- The main goal during the second stage is abolition of fiscal boundaries between Member States. Before the end of 1968, the Commission has to submit to the Council a proposal stating how and when these boundaries will be abolished

The First VAT Directive<sup>41</sup> is adopted on 11 April 1967.

According to art. 3 of the First VAT Directive:

*The Council shall issue, on a proposal from the Commission, a second Directive concerning the structure of, and the procedure for applying, the common system of value added tax.*

The Proposal for a Second VAT Directive is submitted by the Commission to the Council on 14 April 1965. This is the first place where special arrangements for SME are mentioned. In Chapter III *Explanatory comments on certain provisions of the proposed TVA system*, art. 11 it is stated:

*According to general belief the full application of the TVA system proposed in this Directive to small firms may encounter difficulties especially of a technical nature. This is why provision is here made for the possibility of relaxing the rules of application with respect to this category, or indeed to exclude the small-scale firms for the scope of TVA.*

*Given that, on the one hand, the situation of such firms varies greatly from country to country, and that, on the other hand, they have very different capacities of adaptation, it seems neither necessary nor expedient to adopt a common system in this matter. For this reason it was provided that every government should apply to these firms the tax system most suitable in the light of national requirements and possibilities, subject to prior consultation in accordance with Article 13.<sup>42</sup>*

Art. 13 stipulates that prior consultations are required in six cases, one of them is the adoption of special scheme for small firms.<sup>43</sup>

Finally the proposal for introduction for a special treatment of small firms is made in art. 11 of the proposal for a Second Council Directive. The text is as follows:

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39 Terra, Ben, Kajus, Julie; *A guide to the European VAT Directives vol.1, Introduction to European VAT 2010*, p.286

40 Explanatory Memorandum of the Proposal for a second Council directive

41 First Council Directive 67/227/EEC

42 Proposal for a second Council directive, Chapter III *Explanatory comments on certain provisions of the proposed TVA system*, art. 11

43 Id, Chapter III *Explanatory comments on certain provisions of the proposed TVA system*, art. 11

*Each Member State is free, subject to consultation in accordance with Article 13, to apply to small firms, with respect to which the application of the normal TVA system would encounter difficulties, such particular arrangements as may be most suitable in the light of national requirements and possibilities.*<sup>44</sup>

Furthermore, in Annex A the following text is provided:

*To the extent of recourse to the provisions of this Article with respect to transport services as under Annex B, point 5 [i.e., transport of goods and their storage, together with ancillary services], these provisions shall be so applied as to safeguard equal treatment for different means of transport.*<sup>45</sup>

After this proposal the Second VAT Directive is adopted on 11 April 1967. The final version of the text concerning the taxation of small firms is published in art. 14 of the Directive:

*Each Member State may, subject to the consultations mentioned in Article 16, apply to small undertakings whose subjection to the normal system of value added tax would meet with difficulties the special system best suited to national requirements and possibilities.*<sup>46</sup>

In point 27 of Annex A of the Second VAT Directive there is a text regarding art. 11:

*Where this Article is applied to the transport services referred to in Annex B, item 5 [i.e., transport and storage of goods, and ancillary services], it must be so applied as to ensure equality of treatment as between the different modes of transport.*<sup>47</sup>

### 2.3.2 The Sixth VAT Directive

After the adoption of the Second VAT Directive rules regarding the small firms have been made. Nevertheless the provisions regarding small firms published in the Second Directive have some deficiencies. It is clear the lack of specific rules defining “a small firm”. A big room is left for the Member States to develop their own rules covering the special scheme. All this could lead to a situation where this special scheme could be significantly different from one Member State to another.

On 20 June 1973 the Commission submitted to the Council a *Proposal for a Sixth Council Directive on the harmonization of legislation of Member States concerning turnover taxes; Common system of value added tax: uniform basis of assessment*.<sup>48</sup> In the Memorandum of the Proposal for a Sixth VAT Directive the Commission makes several comment regarding the special scheme for SME.<sup>49</sup>

First the Commission reminds the possibility given to the Member States according to art. 14 of the Second Directive. In accordance to this provision a Member State can provide a special scheme for small firms which special scheme “best suited to national requirements and possibilities”. The Commission also points out that this provision is not compatible to the aim of establishing of a uniform basis of assessment of value added tax. In order for this aim to be achieved rules that prevent the possibility for national rules to differ too much from one another shall be adopted. Based on this the Commission provides several measures in order to equalize the rules for SME.

The text regarding the special scheme for small undertakings is published in art. 25 of the Proposal<sup>50</sup>. In accordance with art. 25(1) of the Proposal a Member State, after a consultation with

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44 Id, art. 11

45 Id, Annex A, point 27

46 Second Council Directive 67/228/EEC, art. 14

47 Id, Annex A, point 27

48 COM (73) 950

49 For the full text of Commission's commentaries regarding the special scheme for SME in the Memorandum, please see Appendix 2

50 For the full text of art. 25 of the Proposal for a Sixth Council Directive, please see Appendix 3

the Value Added Tax Committee, may introduce:

- exemption from tax for taxable persons whose annual turnover does not exceed 4,000 units of account<sup>51</sup>
- if appropriate, graduated tax relief for taxable persons whose annual turnover exceeds the maximum amount fixed by the State for total exemption but does not exceed 12,500 units of account<sup>52</sup>

After the submission of the Proposal both the Economic and Social Committee and the European Parliament give their Opinions on 31 January 1974 and 14 March 1974 respectively.<sup>53</sup> In its Opinion the Parliament wants a discretion in the definition of “small undertakings” to be given to the Member States. The Commission do not comply with this request by the Parliament. It retains the turnover as a criterion for a small business to be qualified as such. According to the Commission, too much diversity in the special scheme for SME would possibly create distortions of competition.<sup>54</sup> Finally on 26 July 1974 the following amendments are provided in art. 25:

- *The text of the second sub-paragraph of paragraph 2 of this Article is amended as follows:*

*“However, disposals of tangible or intangible investment property which formed part of the fixed assets of the undertaking, supplies of buildings and of building land, the exempt transactions specified in Article 14 B(d) and (f) and the letting of building shall be disregarded in calculating the turnover.”*

- *The text of paragraph 3 of this Article is amended as follows:*

*“Paragraph 1 a) shall not apply to the transactions specified in Article 4(3) (b) and (c), nor to the transactions specified in the second subparagraph of paragraph 2 of this Article.*

*However, a taxable person who makes an appropriate application may enjoy the exemption provided for in paragraph 1 (a), provided that he is liable for value added tax only in respect of the letting of buildings.”<sup>55</sup>*

After these Proposals the Sixth VAT Directive is adopted on 17 May 1977. The text regarding the special scheme for SME is published in art. 24 of the Directive.

Paragraph 1 of the article allows the Member States which might have difficulties to apply the normal tax provisions to small undertakings to apply simplified provisions such as flat-tax schemes. Member States which have benefited from the options provided in art. 14 of the Second VAT Directive, namely exemptions or graduated tax relief, can retain them if they are in conformity with the value added tax system. For those Member States applying exemption of tax for undertaking with a turnover less than 5,000 European units of account converted in national currency, may increase this threshold up to 5,000 European units of account. On the other hand, Member States applying a graduated tax relief can neither increase the ceiling of the graduated tax relief nor make the conditions for granting it more favorable.<sup>56</sup>

Member States that have not used the option granted in art. 14 of the Second Directive can grant an exemption from tax to taxable persons with a turnover up to 5,000 European units of account converted in national currency.<sup>57</sup>

51 COM (73) 950, art. 25(1)(a)(aa)

52 Id, art. 25(1)(a)(bb)

53 COM (74) 795 Final

54 *Value added tax: the Commission puts forward amendments to its proposal for a Sixth Directive on VAT.* Information Memo P-47/74, July 1974

55 COM (74) 795 Final, art. 25

56 Sixth Council Directive 77/388/EEC, art. 24(2)(a)

57 Id, art. 24(2)(b)

Member States applying the exemption from tax to taxable persons with a turnover equal or higher than 5,000 European units of account converted in national currency, may increase it in order to “maintain its value in real terms”.<sup>58</sup>

Art. 24(3) stipulates that the arrangements regarding exemption from tax and graduated tax relief are valid only to the supplies of goods and services by small undertakings.

Paragraph 4 sets the rules regarding the turnover which serves as a reference for providing exemption from tax and graduated tax relief. It also stipulates that the disposals of tangible or intangible capital assets of an undertaking shall not be taken in consideration for calculating the turnover.

Paragraph 5 precludes the deduction of VAT in accordance with art. 17 by taxable persons which are exempted from tax. They cannot show VAT in their invoices or other documents serving as invoices either.

According to paragraph 6 taxable persons eligible for exemption can either opt for normal VAT arrangements or simplified procedures.

Taxable persons using the graduated tax relief shall be treated as normal taxable persons.<sup>59</sup>

In accordance with paragraph 8 starting from 1 January 1982 the Commission shall report to the Council after consultations with the Member States on the application of the provisions in art. 24.

In 2003 art. 24a is inserted by the Act of Accession<sup>60</sup> then amended by Directive 2004/66/EC:

*In implementing Article 24(2) to (6), the following Member States may grant an exemption from value added tax to taxable persons whose annual turnover is less than the equivalent in national currency at the conversion rate on the date of their accession:*

- *in the Czech Republic: EUR 35 000;*
- *in Estonia: EUR 16 000;*
- *in Cyprus: EUR 15 600;*
- *in Latvia: EUR 17 200;*
- *in Lithuania: EUR 29 000;*
- *in Hungary: EUR 35 000;*
- *in Malta: EUR 37 000 when the economic activity consists principally in the supply of goods, EUR 24 300 when the economic activity consists principally in the supply of services with a low value added (high inputs), and EUR 14 600 in other cases, namely service providers with a high value added (low inputs);*
- *in Poland: EUR 10 000;*
- *in Slovenia: EUR 25 000;*
- *in Slovakia: EUR 35 000.*

### 2.3.3 Proposal for the Recast VAT Directive

On 15 April 2004 the Commission makes a proposal for a Recast of the First and Sixth VAT Directives.<sup>61</sup> According to the Explanatory Memorandum of the Proposal the aim of it is to get rid of obsolete texts and adopt a new more comprehensive structure of the Directive. It also proposes that the provisions should be shortened in order to be not so complex. As a result approximately 50 long articles have been replaced from around 400 new articles which are much shorter and easy to read and understand. According to the Proposal the arrangements regarding the special scheme for SME should be published in Title XII *Special Schemes*, Chapter 1 *Special schemes for small*

<sup>58</sup> Id, art. 24(2)(c)

<sup>59</sup> Id, art. 24(7)

<sup>60</sup> Act of Accession of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia (OJ L 236, 23.9.2003).

<sup>61</sup> COM(2004) 246 Final

*enterprises.*

On 28 November 2006, the so-called Recast VAT Directive<sup>62</sup> is adopted. It enters into force on 1 January 2007.

#### 2.3.4 Turnover thresholds

The rules arranging the turnover threshold is one of the fields in the special scheme for SME where the differences are the most. One of the main aims of the Commission, as it is stated in the Explanatory Memorandum of the Proposal for the Sixth VAT Directive, is to create a common policy regarding the SME scheme. The rules arranging this scheme should not differ considerably from one Member State to another. Notwithstanding this purpose, it is clear that the rules determining the turnover threshold are far from being equal. Due to historical reasons the annual turnover thresholds for exempting small undertakings differ from State to State. The reason for this difference is the time of accession of every State in the EU. As it is mentioned above the nine Member States, already in the Union by the time the Sixth Directive was adopted, have different rules setting up the turnover thresholds for small and medium-sized undertakings, compared to the countries which entered the Union later. For the other seventeen countries accessed after that, different rules apply. Two reasons causing these inequalities can be underlined. First, the opportunity provided in the Sixth Directive by which Member States, that had higher turnover threshold by the time the Directive was adopted, could retain them and even increase them in order to keep their value in “real terms”. And second, the derogations granted to the new Member States entered the Union after the adoption of the Sixth Directive. All this leads to a situation where the thresholds vary from 5,000 EUR to 80,000 EUR.<sup>63</sup> In order to equalize the thresholds limits to some extent, the Commission has made two different proposals.

The first proposal<sup>64</sup> was submitted on 9 October 1986, then amended on 4 November 1987.<sup>65</sup> According to the Amended Proposal art. 24 of the Sixth Directive regarding the special scheme for small and medium-sized enterprises shall be amended by a new article with 11 paragraphs. The proposals can be paraphrased as follows:

##### Art. 24

1. (a) A tax exemption shall be applied by the Member States to taxable persons whose annual turnover is less than 10,000 ECU converted in national currency.  
(b) The same treatment shall be granted to taxable persons with a turnover less than 35,000 ECU converted in national currency.
2. The exemption is valid only to small and medium-sized undertakings.
3. Paragraph 3 defines the turnover which should be used for the purposes of paragraph 1. It also emphasizes that disposals of tangible and intangible capital assets shall not be taken in consideration for calculating the turnover.
4. Taxable persons which benefit for the exemption shall not be eligible for tax deduction in accordance with the provisions of art. 17. They cannot also show VAT in their invoices.
5. Taxable persons eligible for the tax exemption scheme can opt either for a normal VAT treatment or a simplified scheme, if such is available.
6. Simplified schemes shall be introduced by the Member States in accordance with the provisions in sub-paragraphs (a-g)
  - (a) This simplified scheme shall be limited to taxable persons with annual turnover less than 200,000 ECU converted in national currency.
  - (b) The chargeable event shall be the of goods or services supplied.

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<sup>62</sup> Council Directive 2006/112/EC

<sup>63</sup> SEC(2010) 1455

<sup>64</sup> COM(86) 444

<sup>65</sup> COM(87) 524 Final

- (c) As a result, the right to deduct is shifted to the time of payment for the goods or services by the taxable person.
- (d) The transitional provisions set in art. 28(3)(d) are not applicable.
- (e) A return shall be done by the taxable person at least once a year. The Member States have to make effort this date to be the same as the one required from the taxpayer in respect of the direct taxes.
- (f) The taxpayer is responsible to make monthly or quarterly advance payments equal to one-twelfth or one-quarter, respectively, of the net VAT paid the last year. The taxpayer can pay less by declaring that such advance payments are greater than the tax actually due for the current year. In his annual return the taxpayer shall make an adjustment and pay any balance due when he files his tax return.
- (g) For taxable persons which have sufficiently homogeneous purchases, flat-rate percentages for calculating the deductible VAT can be introduced by the Member States. This shall not lead to reduction of tax. Member States wanting to introduce such flat-rate percentages shall inform the Commission according the procedure set in paragraph 8.

6a. Taxable persons eligible for simplified scheme may still opt for normal VAT arrangements.

7. Member States can retain the following schemes:

(a) existing exemption schemes, if these schemes are more favorable to SME than those set out in paragraphs 1 to 5.

(b) existing simplified regime, if it is not less favorable for SME than those set in paragraph 6.

8. A Member State that wants to retain its existing special schemes as set in paragraph 7 or wants to introduce the arrangements set in paragraph 6(g) has to inform the Commission and provide all the relevant information. Details regarding the information used to calculate the flat-rate percentages provided in paragraph 6(g) shall be provided by the Member State. It also shall present the size of purchases made at different rates in the economic sector concerned.

9. The Commission is obliged to inform the other Member States within two months for the measures a Member State is about to introduce pursuant to paragraph 7. If it considers it appropriate, the Commission shall also submit a proposal to the Council with a view to authorize such measures. The Council has to decide by a qualified majority, after an opinion given by the Parliament.

10. The Commission has to revise the thresholds set in paragraph 1 (a) and (b) as well as in paragraph 6 (a) every year, in order to keep their values in real term. This decision shall be taken by 1 October at latest and shall take effect from 1 January next year.

11. The equivalent of national currency of the ECU has to be set by the Commission every year. The rates shall be the ones valid on the first working day of October and taking effect from 1 January.

The second Proposal<sup>66</sup> was submitted on 29 October 2004. It proposes, among other things, the introduction of a common turnover threshold of a maximum of 100,000 Euro. In point 6 of the Explanatory Memorandum of the Proposal the Commission once again emphasizes that the existing arrangements, concerning the SME special scheme, put the different Member States in unequal grounds. It also points out that all the Member States should be more flexible in determining the threshold under which SME should be exempted. The Member States will be given the opportunity to have different thresholds. One for businesses making supply of goods and other for those making supply of services. The following amendments to art. 24 of the Sixth Directive are proposed:

*Article 24 is amended as follows:*

(a) Paragraphs 2, 3 and 4 are replaced by the following:

66 COM(2004) 728 Final

2. Member States may exempt taxable persons whose annual turnover does not exceed a threshold which may be set no higher than EUR 100 000 or the equivalent in national currency at the conversion rate on 1 July 2006. They may apply one or several thresholds, which may not in any case exceed EUR 100.000 or the equivalent in national currency on 1 July 2006.

Member States may revise annually the thresholds they apply. Under that annual review, the maximum threshold of EUR 100 000, or the equivalent in national currency applicable on 1 July 2006, may be raised only in order to maintain the value in real terms of these thresholds.

Member States which have exercised the option under Article 14 of Directive 67/228/EEC to introduce exemptions or graduated tax relief may retain them and the arrangements for applying them if they conform to the VAT system.

3. The exemption provided for under paragraph 2 shall not apply to the following transactions:

(a) transactions carried out on an occasional basis, as referred to in Article 4(3);

(b) supplies of new means of transport carried out in accordance with the conditions specified in Article 28c(A);

(c) supplies of goods and services carried out by a taxable person who is not established in the Member State in which the value added tax is due.

4. The turnover serving as a reference for the purposes of applying the arrangements provided for in paragraph 2 shall consist of the following amounts, exclusive of value added tax:

(a) the value of goods and services, in so far as they are taxed, including transactions which are exempt, with deductibility of the value added tax paid at the preceding stage, pursuant to Article 28(2);

(b) the value of transactions which are exempt pursuant to Article 15;

(c) the value of real estate transactions, financial transactions as referred to in Article 13(B)(d) and insurance services, unless those transactions are ancillary transactions.

However, disposals of the tangible or intangible capital assets of an enterprise shall not be taken into account for the purposes of calculating the turnover.

(b) Paragraphs 8 and 9 are deleted.

This proposal is still not adopted, but it is still on the table at the Council. It was last discussed in the Council in 2007.<sup>67</sup>

## 2.4 Future of the special scheme for small and medium-sized enterprises

The development of the special scheme for SME does not stop with the VAT Directive. The Green paper<sup>68</sup> on the future of VAT includes, among other things, proposals for the future of the special scheme for SME.

The Commission reminds that according to the current legislation in the VAT Directive the special scheme for SME is elective. The introduction of a minimum compulsory level with an option of applying a higher one is proposed. This will lead to a significant reduction of burden born by the small businesses.

The Commission also proposes the introduction of a common threshold for the special scheme for SME. This will eliminate the inequality we have at present. According to the Commission this threshold should be 100,000 Euro, as proposed in 2004. In accordance with the provisions we have at present, the annual threshold is calculated based only on supplies made in the Member State where the SME is established. In order to have a single market it would be more precise if the annual threshold is calculated based on the supplies done in the Union as a whole.

The document also contains a proposal for the SME to be treated as non-taxable persons. This could

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<sup>67</sup> SEC(2010) 1455, pp. 80

<sup>68</sup> Id

lead to less administrative costs by treating the SME similarly to a private individual.

## 2.5 Are SMEs so important?

The special scheme for SME is not put in the Directive without a reason. Small and medium-sized enterprises are significant part of the European economy. According to information from the Commission<sup>69</sup> there are 23 million SMEs operating in the Union. This figure represents 99% of businesses in EU. This makes them a key player in the field of economic growth, innovation employment and social integration. Furthermore, they provide two-thirds of the jobs in the private sector and make around 50% of the value-added created by businesses in the EU. Moreover, 90% of these businesses are micro enterprises with less than 10 employees.

Small and medium-sized enterprises are essential part of the Lisbon strategy.<sup>70</sup> The importance of the SMEs was recognized by the adoption of the European Charter for Small Enterprises<sup>71</sup> adopted on 13 June 2000 and approved 19 and 20 June 2000 at the European Council held in Feira. This Charter recognizes that small enterprises are the backbone of the European economy and leading force for innovation and job creation in the EU. It also emphasizes that the SMEs are the most vulnerable to the changes of the business environment. The main aim of it is to make the EU's economy the most competitive and dynamic knowledge-based one in the world. The small and medium-sized enterprises are considered to be the main driving force for achieving innovation, employment and social integration.

Another step forward in making SMEs more flexible is the adoption of “Small Business Act” (SBA)<sup>72</sup> in 2008. Its aim is to achieve the best possible framework for SMEs and make this framework more SME-friendly. The “Think Small First” principle has been introduced. According to this principle the policy-making process should “promote SMEs growth by helping them tackle the remaining problems which hamper their development.”<sup>73</sup>

The SBA introduces a set of 10 principles. In accordance with them new policies should be adopted on EU and Member State level. These policies have to improve the legal and administrative environment in the Union, which, in turn, will bring added value at EU level. The principles are as follows:

1. Create an environment in which entrepreneurs and family businesses can thrive and entrepreneurship is rewarded
2. Ensure that honest entrepreneurs who have faced bankruptcy quickly get a second chance
3. Design rules according to the “Think Small First” principle
4. Make public administrations responsive to SMEs’ needs
5. Adapt public policy tools to SME needs: facilitate SMEs’ participation in public procurement and better use State Aid possibilities for SMEs
6. Facilitate SMEs’ access to finance and develop a legal and business environment supportive to timely payments in commercial transactions
7. Help SMEs to benefit more from the opportunities offered by the Single Market
8. Promote the upgrading of skills in SMEs and all forms of innovation
9. Enable SMEs to turn environmental challenges into opportunities
10. Encourage and support SMEs to benefit from the growth of markets

69 [http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/index\\_en.htm](http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/index_en.htm)

70 [http://ec.europa.eu/archives/growthandjobs\\_2009/](http://ec.europa.eu/archives/growthandjobs_2009/)

71 Annex III to the Conclusions of the Presidency of the Santa Maria Da Feira European Council of 19 and 20 June 2000.

72 COM(2008) 394 Final

73 Id, pp 3

Point 3 from the above mentioned contains measures regarding VAT. The Commission emphasizes that SMEs face high compliance costs. They bear a disproportional administrative burden compared to larger businesses. While a big company spends around 1 euro per employee caused by a regulatory duty, a small-scale business might spend 10 euros per employee.<sup>74</sup> In accordance to the principle mentioned in point 3 the Commission invites the Member States to adopt the proposal which could permit the increasing of the threshold for VAT registration to be set on 100,000 Euros. On 23 February 2011 the Commission published a Review of the "Small Business Act" for Europe.<sup>75</sup> It presents the results already achieved by the SBA. The most important act related to VAT is the adoption of the invoicing Directive.<sup>76</sup> This Directive gives the opportunity for businesses with a turnover less than 2,000,000 Euro to benefit from cash accounting scheme. According to the provisions in this Directive the eligible businesses can delay accounting for VAT until they receive payment from their customers.<sup>77</sup>

## 2.6 Purpose of the special scheme for small and medium-sized enterprises

The main purpose of the Special scheme is to reduce the administrative costs born by the SMEs. They are greater for them because of the small scale of their business. Furthermore, this special scheme for small and medium-sized enterprises is advantageous not only for the businesses but also for the Member States.

The advantages for the businesses can be divided in two parts. First, it is more advantageous for undertakings which deal with non-taxable persons. By benefiting from the scheme, they don't charge output VAT to entities which cannot deduct this VAT anyway. In this way their prices become more attractive for non-taxable persons. Another advantage comes from the possibility for reduction of the administrative obligations, which is provided in art.272 of the VAT Directive. By excluding the small businesses from the normal VAT arrangements, it is advantageous also for the state's revenue. This is due to the fact that costs on collecting relatively small amounts of VAT might be high.

## 3. Beneficial or not?

There are two essential problems caused by the taxes in general and VAT in particular: the compliance costs and the administration costs. The first are the costs born by the taxpayers, in the case of VAT - by the undertakings. The administration costs are those incurred by the tax authorities. This is why the main purpose of the special scheme for SME is to help small undertakings reducing their compliance costs. On the other hand the introduction of the special scheme can also help the Member States to reduce their administration costs.

In this chapter the author will try to find whether the special scheme is really beneficial for both the businesses and the Member States. He will also check if there are other benefits from applying the scheme.

### 3.1 Benefits for the businesses

It is clear that small-scale businesses bear higher compliance costs than the bigger companies. This is determined by the fact that a great percentage of the costs are constant. A small undertaking has to maintain an invoicing system, to pay for an accountant, etc. in order to comply with his VAT

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74 Report from the Expert Group on "Models to Reduce the Disproportionate Regulatory burden on SMEs", May 2007

75 COM(2011) 78 Final

76 Council Directive 2010/45/EU

77 Further discussion regarding cash accounting will be provided in Chapter 3 of this paper

obligations. The same is valid for the big companies as well. Compared to their scale, however, these costs are much more burdensome for the small-scale businesses. It is hard for the small undertakings to pass these costs to the customers because their market position is not so strong.

It will be neither correct nor true if one claims that special scheme for SME is beneficial for the businesses or not without examining all the situations an undertaking might experience. In order to say whether the special scheme has benefits for the businesses it should be first checked all the situations that a particular business can face. Whether he deals more with end-customers and non-taxable persons or taxable persons? Whether he makes intra-Community acquisitions or not and if so, what is the value of these acquisitions? Whether or not he sells to customers in another Member States? Does he deal with goods subject to excise duty or not? Etc.

### 3.1.1 Trading in the national market

As it is stated above, the compliance costs could be really burdensome for the small undertakings, determined by the small-scale of their operations but relatively the same obligations regarding VAT. Do the provisions of the VAT Directive provide any resolution for this problem? In accordance with art. 272 (1)(d) Member States may release the taxable persons covered by the scheme for SME provided in art. 282 to 292 from some or all obligations referred in chapters 2 to 6 from Title XI *Obligations of Taxable Persons and certain Non-Taxable Persons*. These are the chapters *Identification, Invoicing, Accounting, Returns and Recapitulative statements*. This provision releases the SMEs, among other things, from the obligations for identifying with a VAT number, keeping of invoices, filing of VAT returns and recapitulative statements. All this can reduce significantly the compliance costs born by the small undertakings, which makes it beneficial for the SMEs.

So far it can be concluded that the special scheme for SME is good for reducing compliance costs. Now it is important to check whether the special scheme for SME is beneficial in every scenario.

For undertakings which make business with final consumers or non-taxable legal persons the application of the special scheme could bring double benefit. On one hand the smaller compliance costs commented above and the lack of charging VAT to their customers. Due to the fact that the final customers and non-taxable legal persons cannot deduct any VAT, this makes the goods sold by SME covered by the exemption cheaper, compared to the same goods sold by normal taxable persons. The following fictional example can explain this situation better:<sup>78</sup>

Example 1, a taxable person covered by the exemption scheme:

Input materials, electricity, etc.	1,000 units
VAT paid	+ 200 units
VAT deducted	- 0 units
Value added	+1,000 units
VAT charged	+ 0 units
Final price	2,200 units

Example 2, a registered taxable person:

Input materials, electricity, etc.	1,000 units
VAT paid	+ 200 units
VAT deducted	- 200 units
Value added	+1,000 units
VAT charged	+ 400 units
Final price	2,400 units

<sup>78</sup> For the purpose of the example it is presumed that the VAT rate is 20%

It is visible from the example above that when it comes to do business with final consumers it is more advantageous to be a taxable person exempted from VAT, because you can offer a lower price, all other things being equal. The difference in the prices comes from the fact that in Example 1 VAT is charged only on the input expenses but not on the value added by the undertaking. The difference will be even bigger if the VAT rate is higher and smaller in case of lower VAT rate is applied.

There will be a different situation if a SME covered by the exemption scheme trades primarily with registered taxable persons. Then for these customers, registered taxable persons, it would be more beneficial to buy from another taxable person. This is due to the fact that if the taxable person buys from a trader like this in Example 1, then he would not be able to deduct any VAT because there is no VAT charged and the final price would be 2,200 units. On the contrary, if the same taxable person buys it from a trader like this in Example 2, then he would be able to deduct the charged VAT, namely 400 units. This would make the final price for a taxable person 2,000 units.

The trader from Example 1 has two options if he wants to continue the regime for SME. Either to pass the VAT incurred by him to his client and keep his 1,000 units of value added or to decrease the value added to 800 units in order to maintain a final price of 2,000 units. The first possibility is not very favorable for a customer which is a taxable person eligible for VAT deduction. There is a risk for the trader from Example 1 to lose his VAT registered clients. The other option for him is to bear the VAT by decreasing his own value added. This, of course, would not be profitable for him.

There is a provision in the VAT Directive which helps the latter disadvantage to be resolved. According to art. 290 taxable persons eligible for exemption from VAT can opt for normal VAT arrangements. However, the question with incurring the compliance costs still stays. This puts the SMEs using the special scheme and which have business with registered taxable persons in a difficult position. They have to estimate and choose the less burdensome for them – the compliance costs or the reduction in their value added just in order to stay attractive enough for their registered for VAT clients.

### 3.1.2 Intra-Community acquisitions

The next step is to test whether it is possible to use the special scheme when the undertaking performs operations within the European Union.

Art. 2(1)(b)(i) from the VAT Directive stipulates that the intra-Community acquisition of goods by a taxable person acting as such or a non-taxable legal person from a vendor which is a taxable person and not eligible for the exemption scheme for SME shall be subject to VAT. This means that any SME should register as a taxable person in order to make intra-Community acquisitions. This, of course, could be very costly for the traders, especially for those which make intra-Community acquisitions only occasionally.

A provision is provided in the VAT Directive which helps preventing this. Art. 3(1)(b) stipulates, by way of derogation from art. 2(1)(b)(i), that the intra-Community acquisitions, done by taxable persons which carry supplies of goods and services in respect of which VAT is not deductible, are not subject to VAT. In essence this means that SMEs covered by the special scheme do not have the obligation to register in order to perform intra-Community acquisitions (following art. 289, taxable persons exempt from VAT are not eligible for deduction). This option is not limitless though. Art. 3(2)(a) gives the opportunity to the Member States to set a threshold above which a trader performing intra-Community acquisitions shall still register for VAT. The threshold cannot be less than 10,000 Euro or the equivalent in national currency. Although the thresholds vary from a Member State to another they are around 10,000 Euro<sup>79</sup>, except of Ireland – 41,000 Euro and Great Britain – 70,000 Pounds sterling (approx. 81,843 Euro). This provision makes it possible for the

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<sup>79</sup> For thresholds set by the Member States please see Appendix 1

SMEs using the exemption scheme to continue making intra-Community acquisitions, without registering for VAT up to the limit set by the Member State.

### 3.1.3 Intra-Community supplies

If an exempt undertaking wants to supply to taxable persons within the European Union, there is no need to register for VAT. However, according to art. 139 of the VAT Directive, the exemption provided for normal taxable persons in art. 138(1) is not applicable to SMEs covered by the exemption scheme for small enterprises. Furthermore, going back to art. 2(b)(i) we can see that the intra-Community acquisitions are subject to VAT only if they are done by taxable persons and the vendor is not eligible for exemption covered by the special scheme for SME. This creates two problems for customers of SMEs from another Member State. First, as it is described in Example 1 above, although the trader sells without charging VAT, he cannot deduct VAT (art. 139) which makes his products not so competitive. Second, it is hard for the recipient to know whether the exemption for VAT is a result from the supplier being under the small business scheme or due to intra-Community supply. The difference here comes from the fact that only the intra-Community supply done by a taxable person requires an intra-Community acquisition (art. 2(b)(i)).

### 3.1.4 Distance selling

The situation is completely different when a SME wants to supply goods to final consumers or other trader whose intra-Community acquisitions are not subject to VAT pursuant to art. 3(1). Then, according to art. 33, a SME wanting to perform such supplies has to register in every country he wants to sell. This, of course, could be extremely burdensome not only for a SME but also for a normal taxable person.

Art. 34 provides a solution for businesses which want to make supplies to final consumers and other non-taxable persons within the European Union. According to this provision art. 33 shall not apply if the supplies do not exceed 100,000 Euro or the equivalent in national currency in every Member State a trader wants to sell goods. This threshold shall not be exceeded the current and the previous calendar year. Paragraph 2 of the provision gives the opportunity to the Member States to limit this threshold to only 35,000 Euro or the equivalent in national currency.<sup>80</sup>

This derogation makes the so-called “distance selling” very beneficial for the SMEs covered by the exemption special scheme. First, they do not have to register in every country they make supplies. This registration could be too excessive for them, having in mind their small-scale business. A registration for a small amount of transactions would probably stop the SMEs from making distance selling. The second benefit is actually the same as the one described in Example 1. An exempt undertaking can offer a relatively better price to the final consumer due to the fact that he does not charge VAT on his own value added.

### 3.1.5 New means of transport and goods subject to excise duty

The provisions regarding business with new means of transport and products subject to excise duty are different from the ones already described. If an exempted trader wants to buy such goods from another Member State then he has to register. Art. 3(1)(b) does not exclude them from the goods that are not subject to VAT. This means that an exempted undertaking cannot benefit from the threshold of 10,000 Euro provided in this provision for other goods.

The exemption for distance selling is also not valid for new means of transport and goods subject to excise duty. This leads to a compulsory registration for traders that want to make distance selling of these products.

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<sup>80</sup> Id

These restrictions make impossible the usage of the special exemption scheme by undertakings which want to do business with new means of transport or products subject to excise duties. This is completely normal. First, if one trades with new means of transport, both thresholds provided in art. 3(2)(a) and those for exemption for small enterprises would be exceeded within a few transactions, sometimes even after the first transaction. Due to this reason it would be pointless to allow these exceptions for new means of transport. With regard to the goods subject to excise duty they are put under harder control and it is normal to be excluded from the exemptions valid for SME.

### 3.1.6 Using the scheme Union-wide

One of the biggest disadvantages of the special scheme is that it cannot be used by non-established undertakings. Art. 283(1)(c) limits the usage of the scheme only in the Member State in which the business is established. This leads to a situation where a SME covered by the special scheme for SME makes a supply without charging VAT and in the meanwhile the same supply made by non-established undertaking with turnover below the threshold set by the Member State for the special scheme to the same customer is subject to VAT. This means that a SME cannot benefit from the special scheme in another Member State and has to register regardless the turnover. It is clear that the treatment between established and non-established undertakings is different. In Schmelz case<sup>81</sup> the CoJ examined the problems resulted from this different treatment.<sup>82</sup>

### 3.1.7 The invoicing Directive

One of the main aims of the adoption of the invoicing Directive<sup>83</sup> is to help small and medium-sized enterprises. It allows businesses with threshold higher than the one set by the Member States but less than 2,000,000 Euros to take advantage from the opportunity of cash accounting scheme. By doing this they can postpone accounting for VAT until they receive the payment.

This purpose is set in the preamble of the Directive. Point 4 emphasizes the aim and the ways to fulfill it. This Directive will help SME having problems to pay the VAT to the tax authorities before receiving the payment. To make this happen Member States shall introduce the option to allow VAT to be accounted using a cash account scheme. Using this scheme the supplier pays VAT to the authorities only when he receives the payment and has the right to deduct when he pays for a supply.

Under the normal arrangements the right to deduct VAT arises at the time the tax is chargeable.<sup>84</sup> According to art. 63 of the VAT Directive VAT becomes chargeable when the goods or services are supplied. The invoice Directive inserts art. 167a in the VAT Directive. The provision is as follows:<sup>85</sup>

*Member States may provide within an optional scheme that the right of deduction of a taxable person whose VAT solely becomes chargeable in accordance with Article 66(b) be postponed until the VAT on the goods or services supplied to him has been paid to his supplier.*

Member States which apply this accounting scheme shall set thresholds for the undertakings using the scheme in their territory. This threshold shall be calculated according to art. 288. It cannot be above 500,000 Euro or the equivalent in national currency. Member States have the right to increase this threshold to 2,000,000 Euro or the equivalent in national currency after consulting the VAT Committee. Such consultation is not needed for Member States which have thresholds higher than 500,000 Euro or the equivalent in national currency on 31 December 2012.

81 Case C-97/09, *Ingrid Schmelz v Finanzamt Waldviertel*

82 Further details regarding Schmelz case will be presented in Chapter 4

83 Council Directive 2010/45/EU

84 Council Directive 2006/112/EC

85 Council Directive 2010/45/EU, art. 7

This measure is very beneficial for the small undertakings from cash-flow perspective. The change of the chargeable moment from the moment when the goods and services are supplied (art. 63) to the moment of payment (art. 66(b)) makes it easier for the businesses. Now they have the benefit to pay only when they have received the payment.

On the other hand, it is doubtful whether this cash accounting scheme is good for the customers of the undertakings using it. By changing the chargeable moment also the right to deduct changes. In this situation a customer which is a taxable person has the right to deduct VAT at the time of payment, not at the time he receives the goods or services, as is the normal case. This provokes the need of marking cash-accounting invoices by the customers. They also have to upgrade their accounting systems in order to deduct correctly VAT charged by businesses using the cash-accounting scheme. This, inevitably, will lead to additional costs incurred by the customers. They might not want to continue doing business with such suppliers. This fact puts a question on the benefits from using this scheme.

### 3.2 Benefits for the Member States

The administration costs in collecting VAT are the other side of the coin. One might say that the introduction of a threshold for registering for VAT is not beneficial for the state's revenue. In fact the presence of a threshold and the losses in revenue it creates does not necessarily mean that it is bad for the Member States.

In essence the administration costs represent a reduction in tax revenue. In fact it should be pointed that obtaining figures regarding the administration costs is not an easy task at all. Ebrill et al explains the difficulties of calculating the administration costs in the book "The modern VAT".<sup>86</sup> The different types of organizational structures and reporting practices of the various tax authorities make it hard to separate the costs related to VAT. This task becomes even harder when VAT is administrated together with other taxes by the same officials. Even in the presence of a single VAT department, there might be still some common costs, caused by joint VAT and income tax audits, for example. Although it is hard to estimate the administration costs, Cnossen provides some figures.<sup>87</sup> He determines the administration costs for a "best-practice" VAT at approximately 100 US dollars per registrant annually. The costs mentioned could vary according to the complexity of the VAT. They are much lower when the VAT is simpler. Starting from around 50 US dollars per registrant in New Zealand, with a single non zero VAT rate and approximately 200 US dollars in the United Kingdom, with two VAT rates and substantial zero-rating.

A relatively small amount of businesses contribute for a big proportion of VAT revenues. A small amount of VAT registrants account for 80 percent, 90 percent or even more of VAT collections.<sup>88</sup> This, combined with the administrative costs mentioned above, makes it important for the tax authorities to focus their scarce resources in controlling the "big fishes". It seems more efficient to concentrate on those businesses which account for 90 percent of the turnover in a specific economy.

On the other hand, by introducing a turnover threshold below which undertakings stay outside the scope of VAT the tax authorities lose revenue. The lost is the value added being untaxed, as it is described in Example 1 above. If there were no administrative costs (incurred by the authorities) and compliance costs (incurred by the taxpayers), the perfect threshold would be zero.<sup>89</sup> But when we put these costs in the equation, then a zero threshold would probably not be the best solution. This could lead to two essential problems. First, if there is no threshold this would create compliance costs for the small undertakings and for some of them they could be unachievable. Second, the tax authorities would make

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86 Ebrill, Liam et al., *The Modern VAT*, Washington, D.C. 2001, pp 52

87 Cnossen, Sijbren, *Administrative and Compliance Costs of the VAT: A Review of the Evidence*, Tax Notes, vol. 63, pp. 1609-26

88 Bird, Richard M. and Gendron, Pierre-Pascal, *VAT Revisited; A New Look at the Value Added Tax in Developing and Transitional Countries*, University of Toronto, 2005

89 Ebrill, Liam et al., *The Modern VAT*, Washington, D.C. 2001, pp 117

a lot of administrative costs in order to control all the small businesses. Both problems would cause revenue losses.

The forsake of some revenue is in order to save both compliance and administrative costs. At the end the forgone revenue is only the VAT on the margin, as it is clear from Example 1 above. This is the reason why a threshold that is most efficient both for the small businesses and the revenue should be introduced. Keen and Mintz tries to find the optimal threshold in their study.<sup>90</sup> They also propose that two different thresholds should be introduced. One for businesses supplying services and one for those which supply goods. The threshold for undertakings offering services shall be lower, because it is presumed that the value added is much bigger. However, this is not very common in the Member States, for reasons of simplicity.

## 4. Risk from abusive practices

From this description of the special scheme for small and medium-sized enterprises several problems appear. The first one is the wording in art. 282 under which the scheme is available only to small enterprises. In its recommendation<sup>91</sup> the Commission defines the criteria for a business to be qualified as SME. However, these rules are not relevant for the special scheme with exemption from tax for SME. Here the criteria is the turnover threshold set in every Member State.<sup>92</sup> The problem comes from the fact that it is not clear whether the set turnover limits are valid only for the turnover earned in the specific Member State or in the whole European Union.

In addition, the limitation provided in art. 283(1)(c) might be in breach with the Treaty freedoms, especially the freedom of establishment (art.49 of TFEU<sup>93</sup>) and freedom to provide services (art.56 of TFEU). On the other hand, if it is allowed to use this scheme in every single Member State that provides it, there is a possibility for abusive practices. One can benefit for the scheme in every Member State that provides it, or at least in most of them, and by doing this he might generate a very big turnover without paying any VAT.

### 4.1 Fundamental Treaty freedoms

Basically there are four fundamental freedoms set in the Treaty on Functioning of the European Union, known as Treaty freedoms. They are:

- the free movement of goods (art. 34 of TFEU)
- free movement of persons, which includes
  - free movement of EU citizens (art. 21 of TFEU)
  - free movement of workers (art. 45 of TFEU)
  - freedom of establishment (art. 49 of TFEU)
- freedom to provide or receive services (art. 56 of TFEU)
- free movement of capital and payments (art.63 of TFEU)

Limiting the use of the special scheme for small businesses might be in breach of freedom of establishment and freedom to provide services. According to the freedom of establishment EU nationals can establish in any of the EU Member States and conduct activities there as a self-employed person or via an undertaking.<sup>94</sup> An EU national established in a Member State can benefit from the same conditions as the nationals of the specific state. Also EU nationals have the freedom

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<sup>90</sup> Keen, M. and J. Mintz, *The Optimal Threshold for a Value-added Tax*, Journal of Public Economics

<sup>91</sup> C(2003) 1422

<sup>92</sup> For the thresholds set by the Member States please see Appendix 1

<sup>93</sup> TFEU

<sup>94</sup> Helminen, Marjaana, *EU Tax Law – Direct Taxation* - 2010

to choose the Member State and the form in which they want to do business. The tax treatment cannot be an obstacle for experiencing this freedom. In accordance with the freedom of providing services every EU national residing or established in the Union has the right to provide services in another Member State. He must be treated the same way as the nationals of this particular Member State.

The restriction of these freedoms can be justified by applying measures designed to protect the “public interest”. According to CoJ case-law several reasons are accepted as justifications for tax measures leading to restriction of the basic Treaty Freedoms. They are as follows:

- the need for effective fiscal supervision<sup>95</sup>
- fiscal (territorial) cohesion<sup>96</sup>
- the need to prevent abuse of rights<sup>97</sup>

## 4.2 Schmelz case

Although there is over thirty years of jurisprudence related to VAT issues, the CoJ has only assessed the compatibility of the EU secondary legislation with the Treaty only on very few occasions.<sup>98</sup> This is the case with the Schmelz case, where the CoJ tests the compatibility of the Sixth VAT Directive and the VAT Directive with the fundamental Treaty freedoms, namely the limitation from benefiting from the special scheme for small undertakings set down in art.24(3) and art.28i of the Sixth Directive and art.283(1)(c) of the VAT Directive.

### 4.2.1 Facts of the case

The appellant in the main proceeding is Ms. Ingrid Schmelz, a German national and resident of Germany. She has an apartment in Austria which she lets for a monthly rent of 330 EUR plus operational costs. No VAT is charged on this rent by Ms. Schmelz. After an assessment by the Austrian tax authorities and a deduction of the input VAT paid by her, Ms. Schmelz had to pay VAT to the amount of 334.93 EUR for 2006 and 316.15 EUR for 2007 for the generated turnover of 5,890.90 EUR and 5,936.37 EUR for 2006 and 2007 respectively. According to the appellant during the years in question she did not receive any other turnover in the territory of the Community. Ms. Schmelz relies on art.6(1)(27) of UStG of 1994 and takes the view that as a small undertaking she is exempt of charging VAT, because her turnover is below the threshold set in Austria, namely 35,000 EUR.

On the other hand the Finanzamt considers that Ms Schmelz cannot benefit from the exemption for small and medium-sized enterprises because she is neither a resident nor established in Austria.

Ms Schmelz did not accept these assessments and appealed against them to the Independent Finance Tribunal, Vienna. The Austrian Court was not sure whether the national law, which is consistent with the Sixth Directive and the VAT Directive, was in breach with the primary EU law.

In these circumstances the Independent Finance Tribunal, Vienna decided to stay proceeding and asked CoJ six questions for preliminary ruling<sup>99</sup>.

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<sup>95</sup> Terra, Ben; Wattel, Peter, *European Tax Law*

<sup>96</sup> Id

<sup>97</sup> Id

<sup>98</sup> de la Feria, Rita, *VAT and the EC internal market: The shortcomings of harmonization*

<sup>99</sup> For the questions asked please see Case C-97/09 Ingrid Schmelz v. Finanzamt Waldviertel, par. 26

## 4.2.2 Problems

The problem that occurs from the wording in both the Sixth Directive and the VAT Directive, concerning the SME scheme, is that a Member State allows an exemption from VAT for businesses registered on its territory but, on the other hand, this opportunity cannot be used by undertakings registered in other Member States. By asking these questions the referring court wants to clarify whether art.24(3) and art.28i of the Sixth Directive and art.283(1)(c) of the VAT Directive are consistent with the Treaty Freedoms, especially with art.12 EC (art.18 TFEU), art.43 EC (art.49 TFEU) art.49 EC (art.56 TFEU) as well as the general principle of equality. Along with this, the Austrian court also wants to check whether the term “annual turnover” indicated in art.24 and art.24a of the Sixth Directive and art.284 to art.287 of the VAT Directive means the turnover generated in the particular Member State where the SME Scheme is valid or the turnover from all the Member States in the Community.

## 4.2.3 Main characteristics of the scheme

The advocate general Kokott brought her opinion on 17 June 2010. In the beginning of the opinion she makes several reminders of the main characteristics of the SME scheme. First, she points out that the scheme is a partially harmonized, derogating from the general system of VAT. This is the reason why it has to be interpreted strictly in order to reach its aims. She also reminds the two main objectives of the SME. The first one is to help the small undertakings save expenditures connected with their VAT responsibilities. These expenditures could affect them disproportionately due to the smaller scale of their operations. On the second place is the benefit of the State. Excluding the small undertakings from the field of application of VAT simplifies the tax administration. In this way the administration does not have to levy small amounts of VAT from a large group of small businesses. The administrative costs could be more than the tax levied.

## 4.2.4 Turnover

In order to resolve the problem regarding the turnover, defining a small undertaking as such, the author analyzes the opinion of AG Kokott. This is because the more pedagogical and in-depth approach of the AG.

After the reminders AG decides to answer the fifth and sixth questions. The Commission on the one hand and the Austrian and German governments, on the other, have different view whether the turnover, determining the status of a small undertaking, should be the turnover generated in the specific Member State or the turnover from all transactions in the Community. According to the Commission the turnover from all operations in the Community has to be taken in consideration. This comes from the Commission's interpretation of the main aim of the SME scheme, namely easing the burden on undertakings which operate on really small scale. Otherwise, there is a possibility, although only theoretical, this scheme to be enjoyed even by businesses which have turnover, generated abroad, bigger than the threshold.

The Austrian and German governments take the opinion that the turnover should be only the one, generated in the Member State of registration. They point out the other aim of the scheme – the administrative simplification. In order to collect information from other Member States, the tax authorities have to make excessive expenditures. This is contrary to the aim of administrative simplification.

AG Kokott also points out that another aim of the scheme is the promoting of small undertakings.

She agrees that this aim can be achieved only by taking in consideration of the turnover from the whole EU. She agrees on the possibility of undertakings with turnover bigger than the set threshold to benefit from the SME scheme. Nevertheless, she considers that small undertakings, as a rule, operate on local level and a situation, as described above, is an exception. Furthermore, according to AG's view, even in these exceptional cases an undertaking which has a turnover generated in other Member State will benefit from the SME scheme only in its own Member State. In every other Member State it will be taxed because it is not registered there.

Having in mind all the above mentioned, AG Kokott concludes that the answer to the fifth and sixth questions, regarding the turnover determining a business as a small undertaking, should be that the turnover mentioned in art.24 of the Sixth Directive and art.287 of the VAT Directive “means the sum of the turnover generated by a taxable person in one year in the Member State in which it is established.”<sup>100</sup> The CoJ follows AG's opinion and ruled in its decision: “Articles 24 and 24a of the Sixth Directive and Articles 284 to 287 of the VAT Directive must be interpreted as meaning that the term ‘annual turnover’ refers to the turnover generated by an undertaking in one year in the Member State in which it is established.”<sup>101</sup>

#### 4.2.5 Limitation of Treaty freedoms

In order to answer the first and second questions the Court has to test whether the provisions in the Sixth Directive and the VAT Directive infringe the Treaty freedoms.

##### 4.2.5.1 Freedom of establishment

In regard of freedom of establishment both the Court and AG Kokott refer to *Centro di Musicologia Walter Stauffer*<sup>102</sup> case. According to the rulings in this case a permanent presence and actively management of the property are needed in order for the freedom of establishment to apply. Furthermore, the Court refers also to *Cadbury Schweppes and Cadbury Schweppes Overseas*.<sup>103</sup> This permanent presence should be demonstrated by existence of premises, staff and equipment. As the Court finds out, Ms Schmelz does not meet these conditions. It rules that “the provisions governing freedom of establishment are not applicable in circumstances such as those of the dispute in the main proceedings.”<sup>104</sup>

##### 4.2.5.2 Freedom to provide services

The next thing to be checked is the freedom to provide services. The Court considers that Ms Schmelz letting operations are covered by freedom to provide services. The provisions included in the Sixth Directive and the VAT Directive provide exemption from VAT for small undertakings registered in a particular Member State but do not provide the same exemption to businesses registered in other Member States. The CoJ finds out that an undertaking established in a Member State can provide its services under more advantageous conditions than, for example, an undertaking which is not established in this Member State. Finally, the Court concludes that the fact that small undertakings established outside Austria are excluded from the benefit of the VAT exemption renders the provision of services in Austria less attractive for those small undertakings. Consequently, it entails a restriction on the freedom to provide services.”<sup>105</sup>

<sup>100</sup>Opinion of Advocate General Kokott on Case C-97/09 *Ingrid Schmelz v. Finanzamt Waldviertel*, par. 59

<sup>101</sup>Case C-97/09 *Ingrid Schmelz v. Finanzamt Waldviertel*, par. 77

<sup>102</sup>Case C-386/04 *Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften*

<sup>103</sup>Case C-196/04 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*

<sup>104</sup>Case C-97/09 *Ingrid Schmelz v. Finanzamt Waldviertel*, par. 40

<sup>105</sup>Id, par. 53

#### 4.2.6 Justification of limiting the freedoms

Now, when it is clear that there is a restriction of the freedom to provide services the Court has to examine the possible justification for this restriction.

According to the Austrian, German and Greek Governments consider that the restriction on the freedom of establishment is justified by the need to guarantee the effectiveness of fiscal supervision.<sup>106</sup> The same position is taken by both the Council and the European Commission. The Court refers to *Persche* case<sup>107</sup> to clarify that the guarantee of the effectiveness of fiscal supervision can be an overriding reason. It comes also from *Persche* that the restrictive measure has to comply with the principle of proportionality.

All the parties involved in the case consider that it is hard for the host Member State to control the activities pursued by businesses not established in its territory. Due to art. 272(1)(d) of the VAT Directive Member States may release the small businesses for the formalities provided in art. 213 to art. 271. This is the reason why, in general, the small undertakings do not have VAT registration number in the State of establishment. The parties also point out that the procedures on administrative assistance laid down in Regulation N 1798/2003 and Directive 77/799 cannot provide useful exchange of information in the Member States in which the scheme is introduced. The only way to change this fact is by introducing the formalities laid down in art. 213 to art. 271 of the VAT Directive. This, however, will be contrary to one of the objectives of the SME scheme, namely simplifying of the administration both for the undertakings and the State. In order to guarantee the effectiveness of fiscal supervision of the turnover generated in Member States other than the one a business is established would require two things. First, an introduction of complex formalities and second frequent request for information exchange with all the other Member States. In paragraph 70 of its ruling the Court stresses that it is important to avoid a situation in which a small undertaking benefits from the SME scheme in several Member States and in this way escaping taxation, even though the operations taken as a whole would exceed the limit set for small undertakings. This would be contrary to the aim of encouraging only small businesses.

Considering all these facts the Court comes to a conclusion that “the objective which consists in guaranteeing the effectiveness of fiscal supervision in order to combat fraud, tax evasion and possible abuse and the objective of the scheme for small undertakings, which is to support the competitiveness of such undertakings, justify, first, limiting the applicability of the VAT exemption to the activities of small undertakings established in the territory of the Member State in which the VAT is due and, second, the annual turnover generated to be taken into account being that generated in the Member State in which the undertaking is established.”<sup>108</sup>

#### 4.2.7 Consequences from *Schmelz* case

After the decision in *Schmelz* case there is more clarity in SME scheme arrangements. It is clear from the rulings that the turnover determining a small undertaking as such is only the turnover generated in the Member State of establishment. Furthermore, now it is clear that the limitation of the freedom to provide services is justified by an overriding reason of public interest, namely the need to guarantee the effectiveness of fiscal supervision. As a result small businesses can benefit from the scheme only in the Member State of establishment.

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<sup>106</sup>Id, par. 56

<sup>107</sup>Case C-318/07 *Hein Persche v Finanzamt Lüdenscheid*

<sup>108</sup>Case C-97/09 *Ingrid Schmelz v. Finanzamt Waldviertel*, par. 71

With this decision the Court prevented both the small enterprises and the Member States from incurring administrative costs. If the turnover from all over the EU was taken in consideration this would cause a deviation from one of the aims of the SME scheme – lowering the administrative burden. The Court also prevented the possibility for an undertaking to benefit from the scheme in several different Member States. This could lead to non-taxation of turnovers in different Member States that provide the scheme, although the turnover as a whole is bigger than the turnover in the State of establishment.

#### 4.2.8 Circumventing Schmelz

Now it should be examined whether there is a risk to circumvent the ruling in Schmelz case. This case unambiguously clarifies that the special scheme can be used only by businesses established in a particular Member State and this provision is not contrary to the fundamental freedoms. Nevertheless, this decision still leaves the door open for the opportunity to benefit from the scheme in all Member States that have it. If one wants to do this, the only thing to be done is to incorporate an undertaking in every Member State. This is neither contrary to the decision in Schmelz nor to the provisions of the VAT Directive.

The question now is whether it is worthy to be done. In order to establish an undertaking in a particular Member State one should register there and bear all the administrative burdens caused by such registration. Furthermore, this undertaking has to have office and some personal. From pure economic perspective it seems pointless to incur these costs only to avoid charging VAT on a turnover up to the threshold in this country. The benefit from such an operation is questionable.

It should be concluded that a circumvention of Schmelz case's rulings by establishing undertakings in different Member States is more theoretical than a real opportunity.

#### 4.2.9 Other abusive practices

Another possible way to stay under the threshold is to “switch” from one undertaking to another. One might incorporate several SME liable for the special scheme in a particular Member State. Then, when the turnover is close to the threshold, the operations could be “switched” to the other undertaking. In this way a business might stay under the threshold although in reality it has a bigger turnover.

There are two drawbacks that might appear in this scheme. First, such an operation can easily be qualified as a wholly artificial arrangement which does not reflect economic reality by the tax authorities. In order to prevent this and to show the authorities that this is not a wholly artificial arrangement not only the operations but also the employees and the production assets should be transferred from one undertaking to the other. Here comes the second drawback. A transfer of employees, production assets, etc. would create additional administrative burdens. These costs make the benefit from staying under the threshold significantly smaller. This, at the end, would undermine the aim of this scheme.

However, switching to another undertaking covered by the special scheme for SME every time when the threshold is close to be reached would not be so hard in a case of supplying services, authors, consultants, etc., for example. Then there are no other employees or production assets which have to be switched as well. This artificially splitting could be stopped by introducing a compulsory VAT grouping.<sup>109</sup> By introducing this kind of VAT grouping several taxable persons can be automatically treated as a VAT group once they fulfill all the relevant conditions for group registration.<sup>110</sup>

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<sup>109</sup> Vynke, Kenneth, *VAT Grouping in the European Union: Purposes, Possibilities and Limitations*, International VAT Monitor, July/August 2007, pp 253

<sup>110</sup> Id, pp 254

### 4.3 Direct Cosmetics Ltd. and Laughtons Photographs Ltd. case

One of the benefits from the special scheme for SME, as described in Example 1 in Chapter 3, is that a business covered by the scheme can offer a better price due to the fact that the value added is not charged with VAT. This could be used with abusive objectives. A taxable person who does a business mainly with final consumers could construct his marketing model in a way where the goods or services are supplied first to an undertaking not liable for VAT and then to the customers. In this way the value added in the last stage would not be charged with VAT. This, of course, would make the price more attractive for the consumers, but, on the other hand, would also damage the revenue.

There are provisions in the VAT Directive that can prevent a scheme like this. The first one can be found in art. 11. In accordance to this provision every Member State, after consulting with the VAT Committee, may consider as a single taxable person any legally independent persons established in its territory, which are closely bound to one another by financial, economic and organizational links.<sup>111</sup> However, this cannot prevent the scheme if there are no financial, economic and organizational links between the taxable person and the exempt undertaking which sells to the final consumer.

Another provision, which gives wider powers to the Member States and can prevent a scheme like this, is art. 395. According to art. 395(1) the Council after a proposal from the Commission may authorize a Member State to introduce special measures which derogate from the arrangements in the VAT Directive. This shall be done in order to simplify the collection of VAT or to prevent tax evasion or avoidance. Paragraphs 2-4 of the same article provide the procedures that have to be followed in order for such derogation to be introduced.

#### 4.3.1 Facts of the case

Joint cases *Direct Cosmetics Ltd. and Laughtons Photographs Ltd v. Commissioners of Customs and Excise*<sup>112</sup> examine a special measure that derogates from art. 11.A.1(a) from the Sixth Directive (art. 73 of the VAT Directive), introduced by the United Kingdom. This measure is allowed by art. 27(1) of the Sixth Directive (art. 395(1) of the VAT Directive).

Direct Cosmetics Ltd. is a company making direct sales of cosmetic products which, in so-called “special” situations, cannot be sold on normal retail market. These are surplus stocks, discontinued lines, product wrapped and packaged for Christmas but not sold in time for that occasion, etc. These products are bought by the company directly from the manufacturers on reduced prices. Then they are resold through agents in hospitals, factories and offices.

Laughtons Photographs Ltd. is a company specialized in making photos of classes or individual pupils at school. Then the photos are sold to the school. The company invoices the schools a package of photos and schools, in turn, sell them to the parents. Most of the cases the company does not know the final price photos are sold to the parents. Schools are outside the scope of VAT which means that no VAT on supplies is charged by them.

The result from both sales schemes is that the tax base for VAT is different than the final selling price. No VAT is paid on the difference between the final price and the prices charged by Direct Cosmetics and Laughtons Photographs.

In order to combat schemes like this the United Kingdom adopted a measure derogating from art. 11.A.1(a) of the Sixth Directive (art. 73 of the VAT Directive). This provision, after some amendments, is provided in Paragraph 3 of Schedule 4 to the value-added Tax Act 1983. The

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<sup>111</sup>Council Directive 2006/112/EC, art. 11

<sup>112</sup>Joint cases 138/86 & 139/86 *Direct Cosmetics Ltd. and Laughtons Photographs Ltd v. Commissioners of Customs and Excise*

wording of the provision is as follows:

*"Where -*

*( a ) the whole or part of a business carried on by a taxable person consists in supplying to a number of persons goods to be sold whether by them or others, by retail, and*

*( b ) those persons are not taxable persons, the Commissioners made by notice in writing to the taxable person direct that the value of any such supply by him after the giving of the notice or after such later date as may be specified in the notice shall be taken to be its open-market value on a sale by retail ."*

Based on this paragraph the Commissioners of Customs and Excise made a direction to Laughtons Photographs Ltd. By doing this they informed them that from 30 June 1985 the value for calculating the VAT on any supplies of goods to non-taxable persons and where these goods are sold by the non-taxable persons by retail will be the the open-market value on a sale by retail. Soon after this, namely on 5 July 1985, an identical direction was sent to Direct Cosmetics Ltd.

Both companies appealed against these directions to the London Value-added Tax Tribunal, maintaining that the directions were invalid because they were outside the limits of the purposes referred to in art. 27(1) of the Sixth Directive. The appellants also considered that according to art. 11.A.1(a) of the Sixth Directive they were liable for VAT only on the value of the consideration they really received.

The London Value-added Tax Tribunal stayed the proceedings and asked five questions to the CoJ.<sup>113</sup> Then CoJ decided to paraphrase the questions asked. In essence they were as follows:<sup>114</sup>

*( a ) whether Article 27 ( 1 ) of the Sixth Directive permits the adoption of a derogating measure, such as that at issue, where the taxpayer carries on business in a certain manner not with any intention of obtaining a tax advantage but for commercial reasons;*

*( b ) whether Article 27 ( 1 ) permits the adoption of a measure such as that at issue which is not applicable to all, but only to some, taxable persons who sell to non-taxable resellers;*

*( c ) whether the Council' s authorizing decision is invalid on account of a procedural defect;*

*( d ) whether the Council' s authorizing decision is invalid on substantive grounds and, in particular, whether the authorized measure is disproportionate to the objective referred to in Article 27 ( 1 ), namely the prevention of certain types of tax evasion or avoidance.*

The author considers only questions (a) and (b) relevant to this paper. For that reason only they will be discussed below.

#### 4.3.2 Evasion or avoidance? Does it matter?

In answering the first question CoJ first clarifies that the wording of art. 27 makes a difference between the concept of avoidance and that of evasion in all language versions. Where avoidance is a purely objective phenomenon while evasion involves an element of intent. To consolidate this affirmation the Court points out the historical background of art. 27. In the Second VAT Directive only the concept of "fraud" is mentioned, while in the Sixth Directive also the concept of tax avoidance is mentioned. This shows the legislator intent to add a new element to the pre-existing concept of tax evasion. An intention, which is an essential part of tax evasion, is not a requirement for the existence of tax avoidance.

The Court also points out that the aforementioned interpretation is in conformity with the principle governing the system of VAT. In accordance to this principle all factors which lead to distortion of competition at national and Community level shall be eliminated. The tax to be imposed has to be

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<sup>113</sup>Id, par. 16

<sup>114</sup>Id, par. 18

as neutral as possible and also has to cover all the stages of production and distribution. First, the CoJ reminds the title of the Sixth Directive - “uniform basis of assessment” of VAT. Second, it recalls the second recital in the preamble to the Sixth Directive which refers to “a basis of assessment determined in a uniform manner according to Community rules”, also the ninth recital which states: “the taxable base must be harmonized so that the application of the Community rate ... leads to comparable results in all the Member States”. At the end the Court concludes that “the system of value-added tax is concerned principally with objective effects, whatever the intentions of the taxable person may be”.<sup>115</sup>

Considering all this the Court answers that art. 27(1) of the Sixth Directive allows the adoption of a measure derogating from art. 11.A.1(a) of the same Directive even when the taxable person doing business with not intention to obtain a tax advantage but for commercial reasons.

#### 4.3.3 Flexibility of the derogating measure

To provide an answer to the second question the Court first explains that companies using the same or similar trading schemes as those of Direct Cosmetics Ltd. and Laughtons Photographs Ltd. are not all the same size. This fact makes them not equally significant to the functioning of the system of VAT. A failure to apply derogating measures in order to prevent certain tax avoidance to taxable persons trading mainly to exempt resellers would lead to continuing losses of tax revenue and to a distortion of competition. The situation will not be the same in a case of a taxable person selling to non-taxable reseller only occasionally and to smaller extend. In order to give useful tool for dealing with different economic situations, art. 27(1) allows the Member States to adopt measures derogating from the Sixth Directive to the specific purpose for which they are adopted. Different treatment can be allowed only if justified by objective circumstances.

After taking in consideration these treatment the Court answers that art. 27(1) of the Sixth Directive allows the adoption of a derogating measure which is applicable only to certain taxable persons among all of them trading with non-taxable resellers. The condition is that this treatment shall be justified by objective circumstances.

#### 4.3.4 Consequences of the case

The decision in the joint case Direct Cosmetics Ltd. and Laughtons Photographs Ltd. is very important for Member States in their fight against revenue losses and distortion of competition caused by the same selling schemes or similar like those in the case. After this decision two things are clear. First, a Member State may provide a derogating measure not only in the presence of tax evasion but also when there is only tax avoidance caused by normal business relations. The second thing is that a Member State is allowed to apply such a measure only to certain taxable persons trading with exempt undertakings. However, in order to be introduced such a measure, a permission from the Council is needed.<sup>116</sup> This possibility makes the Member States really flexible. Now they can apply the derogating measures only to those taxable persons which cause significant losses to the tax revenue and create distortion in competition.

## 5 Conclusion

The special scheme for small and medium-sized enterprises underwent significant changes from its first appearance in the Second VAT Directive to the present arrangements in the VAT Directive. The special scheme, as it was provided in the Second Directive, gave a wide range of discretion to the Member States with regard to the details defining a “small firm”, turnover thresholds, etc. It was

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<sup>115</sup> Id, par. 23

<sup>116</sup> Council Directive 2006/112/EC, art. 395

possible to have special schemes which differed considerably for one Member State to another. The purpose of all changes of scheme was always to make a common policy for small undertakings. A lot of changes have been made. In the present scheme rules are clearer and common to a great extent. Nevertheless, there are still differences in the field of turnover thresholds. Although two proposals for unification of the thresholds in all Member States have been made, there are still significant differences among the Member States which provide the special scheme. Perhaps this will be one of the main changes in the future development of the scheme. Disregarding the differences that exist, the special scheme retains its main characteristic – to provide a simplified VAT treatment for small and medium-sized undertakings.

The benefit from the special scheme for the businesses is not unconditional. It depends on the fact whether a particular undertaking trades mainly with final consumers and non-taxable persons or with taxable persons. In the first case the usage of the scheme gives double benefit to the business using it. First, less compliance costs and second – better prices caused by the fact that its own added value is not charged with VAT. In the opposite situation, when most of the customers are taxable persons, there is a cumulative effect caused by the fact that SME covered by the special scheme cannot deduct their input VAT. Here the SMEs have to bear the VAT they cannot deduct by lowering their added value otherwise they risk their prices to be higher and not very competitive. The advantage from lower compliance costs remains. SMEs which trade mostly with taxable persons have to calculate which scenario is more favorable for them – to lower their value added but benefit from the lower compliance costs or to opt for a volunteer register for VAT and bear the compliance costs.

With regard to the SMEs which trade in the Union there is no obstacles to use the special scheme. The only limitation in this field is that the scheme can be used only in the Member State where the undertaking is established.

A small amount of taxable persons contribute for a big proportion of VAT collected. By introducing the special scheme and leaving the “small fishes” outside the tax net, the Member States can spend less money on administrative costs. This fact makes the scheme beneficial also for the state revenue, although it looks just the opposite on first sight.

Both Schmelz case and Direct Cosmetics Ltd. & Laughton Photographs Ltd. case show that the special scheme is not vulnerable from abusive practices.

In the first case the CoJ finds that the limitation provided in art. 283(1)(c) is not contrary to the Fundamental freedoms. This makes impossible to benefit from the scheme in every Member State which provides it. This decision still can be circumvented by establishing an undertaking in every Member State. But having in mind the compliance costs one has to bear in order to register an undertaking in every Member State, this scenario is more theoretical than a real one.

After the Direct Cosmetics Ltd. & Laughton Photographs Ltd. case there is no doubt that Member States have good tools in their fight with schemes using the special treatment for SME for abusive practices. After the decision of the Court it is clear that a Member State can adopt a special derogating measure not only against tax evasion but also against tax avoidance. Although this is not unconditional and a permission from the Council is needed first. Furthermore, this measure can be flexible and a Member State can use it only against specific taxable persons which create significant losses to the tax revenue.

Appendix 1 *Thresholds for SME*

Member State	Threshold for application of the special scheme for acquisitions by taxable persons not entitled to deduct input tax and by non-taxable legal persons <sup>1</sup>		Threshold for application of the special scheme for distance selling <sup>2</sup>		Exemption for small enterprises <sup>3</sup>	
	National currency	Euro equivalent	National currency	Euro equivalent	National currency	Euro equivalent
Belgium	€11.200	-	€35.000	-	€5.580	-
Bulgaria	20.000 BGN	10.226	70.000 BGN	35.791	50.000 BGN	25.565
Czech Republic	326.000 CZK	13.318	1.140.000 CZK	46.570	1.000.000 CZK	40.851
Denmark	80.000 DKK	10.730	280.000 DKK	37.557	50.000 DKK	6.707
Germany	€12.500	-	€100.000	-	€17.500	-
Estonia	€10.226	-	€35.151	-	€15.978	-
Ireland	€41.000	-	€35.000	-	€75.000 or €37.500	-
Greece	€10.000	-	€35.000	-	€10.000 or €5.000	-
Spain	€10.000	-	€35.000	-	None	None
France	€10.000	-	€100.000	-	€89.000 or €52.000 or €34.600	-
Italy	€10.000	-	€100.000	-	€30.000	-
Cyprus	€10.251	-	€35.000	-	€15.600	-
Latvia	7.000 LVL	9.932	24.000 LVL	34.052	35.000 LVL	49.659
Lithuania	35.000 LTL	10.137	125.000 LTL	36.203	100.000 LTL	28.962
Luxembourg	€10.000	-	€100.000	-	€10.000	-
Hungary	2.500.000 HUF	9.164	8.800.000 HUF	32.257	5.000.000 HUF	18.328
Malta	€10.000	-	€35.000	-	€35.000 or €24.000 or €14.000	-
Netherlands	€10.000	-	€100.000	-	None	None
Austria	€11.000	-	€35.000	-	€30.000	-
Poland	50.000 PLN	12.592	160.000 PLN	40.293	150.000 PLN	37.774
Portugal	€10.000	-	€35.000	-	€10.000 or €12.500	-
Romania	34.000 RON	8.071	118.000 RON	28.012	119.000 RON	28.249
Slovenia	€10.000	-	€35.000	-	€25.000	-
Slovakia	€13.941,45	-	€35.000	-	€49.790	-
Finland	€10.000	-	€35.000	-	€8.500	-
Sweden	90.000 SEK	10.190	320.000 SEK	36.232	None	None
United Kingdom	70.000 GBP	81.843	70.000 GBP	81.843	70.000 GBP	81.843

## Appendix 2

*Article 14 of the Second Directive provides that each Member State may, subject to consultations, apply to small undertakings whose subjection to the normal system of value added tax would meet with difficulties the special system best suited to national requirements and possibilities.*

*Despite the more far-reaching requirements of the establishment of a uniform basis of assessment for value added tax, this provision is nonetheless compatible to a certain extent with this aim, on condition that it can be reconciled with the need for a common policy for small undertakings.*

*Such a common policy should prevent national measures which differ too much from one another from giving rise to doubt as to the transparency and impartiality of the tax and as to its balanced contribution to the Community's own resources.*

*In this respect it would seem adequate to provide, within a common framework, for a number of possibilities which Member States may use to enable them to cope with problems posed by the application of value added tax to small undertakings.*

*Article 25(1a) of the draft provides firstly for the exemption from tax of taxable persons whose annual turnover net of tax does not exceed 4,000 units of account.*

*Secondly, provision is made for the granting of graduated tax relief ('*décote*') for taxable persons whose annual turnover net of tax does not exceed 12,500 units of account. This provision supplements the previous one. It should enable Member States wishing to grant exemption to ensure a smooth and fair transition to the normal system of taxation. However, it must be stressed that graduated tax relief can only exist as a measure marginal to exemption. In fact, if it were able to exist on its own, it would only constitute a subsidy for the taxable persons concerned, and as such there would be no grounds for its existence.*

*As regards the selection of criteria for determining the area of application of exemption and possible graduated tax relief, turnover was the criterion finally chosen. This would in fact present the least number of complications for calculation by the taxable person and verification by administrative bodies.*

*Each Member State applying exemption and graduated tax relief will determine the limits and conditions depending on its own requirements within a Community framework. It will therefore determine, in particular:*

- *whether the national limits within which exemption and graduated tax relief might be applied will be at the highest level or beyond it;*
- *whether the national limits will be expressed in terms of turnover or of value added, the latter clearly needing to be compatible with Community criteria expressed in terms of turnover net of tax;*
- *whether exemption and graduated tax relief should be identical or different in the case of persons supplying services and producers/retailers, depending on the nature of the activity in which they are engaged;*
- *the reference period during which the taxable person must fulfil the conditions for exemption*

*Exemption and graduated tax relief are liable to play a part in overcoming difficulties which may be encountered by the smallest undertakings when applying value added tax. In addition, they may simplify the task of tax authorities. Nevertheless, a system of exemption and graduated tax relief cannot be considered as normal within the framework of a general tax on consumption such as value added tax. In addition, the coexistence of different special national systems could hinder the suppression of fiscal borders. This is the main reason why the proposed provisions are of a transitional nature.*

*Article 25(1b) stipulates that each Member State is entitled to introduce simplified procedures for charging and collecting the tax, provided that the amount of tax to be paid shall not thereby be reduced. Subject to this, each Member State shall draw up detailed rules for its own simplified schemes depending on its own ideas and possibilities.<sup>117</sup>*

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<sup>117</sup>COM (73) 950 Proposal for a Sixth Council Directive on the harmonization of legislation of Member States concerning turnover taxes; Common system of value added tax: uniform basis of assessment, Explanatory note, pp. 27-29

## Appendix 3

*1. Where the application of the normal tax scheme to small undertakings would give rise to difficulties, each Member State may, under such conditions and within such limits as it may prescribe, and subject to consultation with the Value Added Tax Committee as provided for in Article 30, apply:*

*a) until such time as the objective specified in Article 4 of the First Directive (67/227/EEC of 11 April 1967) is attained;*

*aa) exemption from tax for taxable persons whose annual turnover does not exceed 4,000 units of account; and*

*bb) if appropriate, graduated tax relief for taxable persons whose annual turnover exceeds the maximum amount fixed by the State for total exemption but does not exceed 12,500 units of account;*

*b) simplified procedures for charging and collecting the tax, provided that the amount of tax to be paid shall not thereby be reduced.*

*2. The relevant turnover for the purposes of application of paragraph 1 a) shall be the total pre-tax amount of the supplies of goods and services defined in Articles 5 and 7, including exempt supplies and supplies made in another country.*

*However, disposals of tangible or intangible investment property which formed part of the fixed assets of the undertaking, supplies of buildings and of building land, the transactions specified in Article 14 B d) and f) and the letting of buildings shall be disregarded in calculating the turnover.*

*3. Paragraph 1 a) shall not apply to taxable persons whose main or subsidiary business consists of real property transactions, nor to the transactions specified in the second subparagraph of paragraph 2.*

*4. Taxable persons totally exempted from tax shall not be entitled to deduct tax invoiced to them or to mention the tax on invoices issued by them or any other documents in that behalf. They may, however, opt for the normal value added tax scheme and, where applicable, qualify for the graduated relief provided for in paragraph 1 a)*

*5. Without prejudice of the application of paragraph 1 b), taxable persons who qualify for graduated relief shall be treated as taxable persons subject to the normal value added tax scheme.<sup>118</sup>*

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<sup>118</sup> COM (73) 950 Proposal for a Sixth Council Directive on the harmonization of legislation of Member States concerning turnover taxes; Common system of value added tax: uniform basis of assessment, art. 25

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