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**The VAT Treatment of Small Undertakings in the EU**

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## Table of Contents

LIST OF ABBREVIATION.....	i
1.CHAPTER ONE: INTRODUCTION .....	1
1.1. Background.....	1
1.2. Purpose and Research Questions.....	2
1.3. Method and material.....	2
1.4. Delimitations .....	2
1.5. Outline of the thesis.....	2
2. CHAPTER TWO: OVERVIEW OF THE SMEs EXEMPTION SPECIAL SCHEME .....	3
2.1. Purpose of the scheme- The need for special treatment .....	3
2.2. The definition of SMEs .....	5
2.2.1 A definition based on annual turnover .....	6
2.2.2. A definition based on payable VAT .....	7
2.3. Main characterizations of the special scheme that requires special attention.....	8
2.3.1. Input VAT deduction and opting for registration .....	9
2.3.2. Intra-Community supply and acquisition of goods by SMEs.....	9
3. CHAPTER THREE: RELEVANT ISSUES FOR CONSIDERATION IN THE SPECIAL SCHEME....	110
3.1 Input VAT deduction and VAT cascading .....	10
3.2 Neutrality and fair competitions .....	13
3.3 Efficiency of the special treatment of SMEs .....	16
4. CHAPTER FOUR: OTHER POSSIBLE APPROACHES TO THE TREATMENT OF SMEs.....	18
4.1 Special scheme (exempting business from the normal arrangement of VAT) .....	18
4.1.1 The common flat rate scheme for farmers .....	18
4.1.2. The Equalization tax scheme .....	21
4.1.3. Graduated tax relief (curving scale) .....	23
4.2. Simplification methods that can be used without exemption of SMEs .....	24
4.2.1. Cash flow method (cash accounting).....	24
4.2.2. Relying less on the importance of invoices .....	26
4.2.3. Softening Reporting obligations .....	28
4.2.4. Simplifying Rates: A reduced rate for labor intensive small business and standard rates .....	31
5. Summary and conclusion .....	32
Bibliography.....	iii

## LIST OF ABBREVIATION

AG	Advocate General
Art	Article
CFRSF	common flat rate scheme for farmers
DKK	Denmark Kroner
FRF	flat-rate farmer
EC	European Community
ECU	European currency unit
CJEU	Court of Justice of the European Union
EU	European Union
EU VAT	European Union value added tax
IMF	International monetary fund
No	Number
OECD	Organization for Economic Cooperation and Development
P	page
Par-	Paragraph
Pp	pages
R&D	Research and development
SEK	Swedish Kroner
SME	Small and Medium-sized enterprises
UEAPME	European Association of Craft, Small and Medium Enterprises
VAT	Value Added Tax
Vol	Volume

# 1. INTRODUCTION

## 1.1. Background

Even if one might get the impression that most businesses in Europe are conducted with large, multinational enterprises, the facts on the ground show that 99% of all European businesses are small and medium enterprises that contribute for more than half of the total value-added created in the EU.<sup>1</sup> The SME sector as a whole delivered 57.6% of the gross value added and 66.5% of all European jobs during 2012.<sup>2</sup> SMEs are also a major source of entrepreneurial skills and innovation.<sup>3</sup> This importance of SMEs shows that sound taxation policy that can provide the right conditions in which SMEs can be utilized is important for Europe's economy.

The significance of these enterprises is being widely recognized through different mechanisms. Among this the adoption of the "Small Business Act"(SBA) in 2008, the special scheme in the VAT Directive and provision of state aid aiming to benefit these entities are worth mentioning. Similarly, after the Treaty of Rome paved a way for harmonization<sup>4</sup> consecutive Directives harmonizing VAT were adopted which provide for a special scheme for SMEs.<sup>5</sup> In response to the treaty of Rome regarding harmonization of VAT in the EU, it was through the Second Directive the special scheme for SME was first incorporated in the EU VAT.<sup>6</sup> Similarly, the current VAT Directive (hereinafter the Directive) provides for a special scheme for SME under Title XII. This scheme is primarily based on the exemption from VAT registration based on registration thresholds. However, it also allows gradual relief and a flat rate deduction of input VAT to certain countries and types of activities respectively. Through this scheme, a SME is relieved from the heavy administrative and compliance burdens of value added tax.

Even if this scheme is stipulated to be a simplification method, it is not as simple as it is stated, and it has various drawbacks. This special treatment of SMEs challenges the intra-Community supply of goods made by SMEs. Further, even if it is known that VAT should not burden traders as it is designed to tax the expenditure for consumption, this scheme denies deduction of input VAT for business covered by the scheme resulting in cumulation or loss of VAT registered customers. Therefore, there is a need to discover and conduct more research on different methods that could be used for VAT treatment of SMEs that are a substantial part of the European economy.

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<sup>1</sup> European Commission, 'Fact and Figures About the EU's Small and Medium Enterprise (SME)'

<[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)> accessed 3/31/2014

<sup>2</sup> European Commission, *A Recovery on the Horizon?* (Annual report on European SMEs, 2012/2013) P 10

<sup>3</sup> European Commission, *The New SME Definition User Guide and Model Declaration* (Enterprise and industry publications, 11 Mar 2005) p 5(here in after *The New SME Definition User Guide* )

<sup>4</sup> EEC Treaty Establishing the European Economic Community, 25 March 1957 (Treaty of Rome), Art 99

<sup>5</sup> First Council Directive 67/227/EEC of 1967, Second Council Directive 67/228/EEC of 1967, Sixth Council Directive 77/388/EEC of 1977, Council Directive 2006/112/EC of 2006, Council Directive 2009/162/EU of 22 December 2009

<sup>6</sup> Second Council Directive 67/228/EEC; Ben Terra & Julie Kajus, *Topical Analyses - A guide to the European VAT directive* (Chapter 12, Special schemes, , Amsterdam, IBFD, 2013) (here in after Ben Terra & Julie Kajus, *Commentary*)

## 1.2. Purpose and Research Questions

It has been noted that the current treatment of SMEs in the EU is only transitional, and it should be replaced by uniform treatment of SMEs. In line with this, the purpose of this paper is to analyze the distinct characteristics and issues related with exemption of SMEs from the VAT system and what other methods could be implemented for effective management and utilization of SMEs by addressing their need. In order to achieve its, goal this thesis aims to answer the questions;

- Why do SMEs need special treatment?
- What is the current exemption scheme as it is?
- What is the effect of the exemption scheme on the right to deduct, cascading, fair competition, neutrality and effectiveness of the tax system? and
- What other special scheme and simplification methods could be applied to address the need of extending special treatment for SMEs?

## 1.3. Method and material

Different tools will be employed to conduct the research. These are legal analysis, case analysis, and literature review. Both descriptive and analytical writing methods will be used depending on the issue under discussion. In order to get concrete data, the researcher has endeavored to include all relevant up to date materials discovered throughout the research period.

## 1.4. Delimitations

The scope of this thesis is limited to EU VAT. The practices of other countries will only be mentioned to show the practice and useful experience that can be beneficial for EU VAT to adopt. The thesis will not deal with all the problems of the exemption scheme, but rather focus just on problems related to denial of input VAT deduction, VAT cascading, neutrality, fair competition and effectiveness. Further, it is not the aim of the thesis to conclude which approach is better from the rest, but rather just to discuss each approach to find out the possible methods that could be implemented to address the needs of SMEs. Since the scope of this thesis is VAT, those methods of simplification that are only relevant for income tax purpose are excluded from the thesis.

## 1.5. Outline of the thesis

- ❖ Following the current chapter that provides the introduction of this thesis, chapter two of the thesis is devoted to the general introduction of the special scheme for SMEs under EU VAT. In this chapter, the writer has examined how businesses are defined as SMEs, the need for the special treatment as well as the characteristics of the SMEs scheme under the current VAT. The aim of this chapter is to give readers the general understanding of the current special scheme of SMEs in the EU and find out the reason for the special treatment of SMEs.
- ❖ Chapter three of the thesis focuses on alleged drawbacks of the scheme. Under this chapter, the issues of the right to deduct and VAT accumulation; neutrality and fair competition; and effectiveness of the exemption will be discussed. The aim of this chapter is to give further special issues that need to be considered in the different methods of handling SMEs and evaluate the exemption scheme based on these principles.

- ❖ Chapter four of the thesis particularly focuses on other possible approaches for the treatment SMEs (other than the general exemption enshrined in the EU VAT). Special simplification methods and schemes such as the common flat rate, the cash accounting system, the equalization scheme be discussed. Simplification methods that could relieve SMEs from the most burdensome eras of VAT such as invoices, VAT returns, accounting methods and rates are illustrated. The aim of this chapter is to identify the relevant simplification methods and other schemes that may be implemented by Member States.
- ❖ Finally yet importantly, summary and conclusions are presented.

## 2. CHAPTER TWO- OVERVIEW OF THE SMEs EXEMPTION SPECIAL SCHEME

Under the current VAT Directive, Small businesses have been subject to special schemes, which exempt them from registering for VAT. However, before discussing the relevant issues that must be considered under this scheme, and the other possible approaches for the treatment of SMEs, it is important first to explore why SMEs need special treatment. Therefore, under this chapter the purpose of the special treatment of SMEs will be examined. In particular, the disproportionality of VAT compliance and administrative costs on SMEs will be discussed. After this, the next vital issue will be identifying which enterprises could be defined as a small business that requires special treatment. This is particularly relevant since categorizing businesses, as SMEs while they do not have the special characteristics that justify the aim of the special treatment will defeat the purpose of the special scheme. Therefore, the different mechanisms that are used for categorizing undertakings as SMEs will be discussed in light of the Directive and other relevant sources. After exploring these issues, this chapter will discuss, in particular, the special features of the exemption scheme that require special attention regarding input VAT deduction and intra-Community transactions.

### 2.1.Purpose of the scheme- The need for special treatment

An essential element of the EU VAT is that it is collected in all stages of production and distribution. Despite these, SMEs face special characteristics, which require different treatment that seems to make them eligible for VAT exemption and simplified procedures. As stated by the OECD,

*“The main reasons for excluding “small” businesses are that the costs for the tax administration are disproportionate to the VAT revenues from their activity and, similarly, VAT compliance costs would be disproportionate for many small businesses.”<sup>7</sup>*

Hence, the extension of special treatment might be for the benefit of both tax authorities and the small businesses. From the perspective of SMEs, the burden could be an issue of difficulty in terms of finance, time and the necessary skill.

Since the VAT administration cannot be done just by mutual trust between the taxable person and the authorities, taxable persons should maintain various ranges of requirements such as bookkeeping, invoicing and VAT return declarations.<sup>8</sup> This VAT compliance burden has a great

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<sup>7</sup> OECD, *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administration Issues*, (OECD Publishing, 2012) P 16 (here in after *Consumption Tax Trends 2012*)

<sup>8</sup> Case C-321/02 *Finanzamt Rendsbug v Detlev Harbs*, C:2004:142, Opinion of AG Léger, Par 3

impact on business, especially for the smaller ones.<sup>9</sup> VAT compliance cost is highly regressive; meaning the smaller the turnover, the greater the compliance burden. This is because the costs for keeping invoice, hiring a tax expert and keeping accounts are constant.<sup>10</sup> Therefore, VAT compliance costs are highly regressive on businesses below certain threshold.<sup>11</sup> As a result, a small business is more burdened by tax compliance than larger one. In line with this VAT is included in the joint list of the most burdensome policy areas for SMEs.<sup>12</sup>

Furthermore, the nature of this business does not have favorable conditions to hire tax experts nor do owners usually have the necessary tax background. A small business is usually an entrepreneur or might even be conducted to satisfy one's own hobby.<sup>13</sup> Thus, imposing heavy administrative costs might end up discouraging the continuation of these activities if the gain is not worth the pain. On the other hand, as most small business could be the starting point of multibillionaire companies, there needs to be a policy that protects these innovators through relieving them from the VAT burden at least until they transform into well-rooted larger companies. The European Charter for small enterprises that declares its commitment to adopt a tax system suitable to "reward success, encourage startups, favor small business expansion and job creation, and facilitate the creation and the succession in small enterprises" further affirms this.<sup>14</sup>

A tax policy has to try, as much as possible, to encourage traders to be willing to be covered under the legal framework. However, if the administrative burden is unbearable to small business they will choose to undertake their earning through the informal economy.<sup>15</sup> This needs more emphasis in the light of small business than the bigger ones because a small business has more ability to be invisible to the eyes of the tax authority and remain undetected compared to bigger ones. Thus, the tax policy of a country needs to extend special treatment to ensure the survival of small business in the formal economy.

In contrast to the above reasons, another reason for special treatment of SMEs is for the sake of the tax authority. Even if small undertakings are great in number, the revenue collected from them is low making the administrative cost of collection incurred by the tax authority disproportional with the tax collected.<sup>16</sup> Therefore, in some instances, if both the compliance and administrative costs are taken into account, it might result in negative tax collection.<sup>17</sup> Thus, depending on the

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<sup>9</sup> OECD, *Businesses' Views on Red Tape: Administrative and Regulatory Burdens on Small and Medium-sized Enterprises, Cutting Red Tape*, (OECD Publishing 2001) 53, also see Susan Symons, Neville Howlett, Katia Ramirez Alcantara, *The impact of VAT Compliance on Business* (pwc, Pricewaterhouse Coopers 2010)

<sup>10</sup> Vasil Milev, 'Special Scheme for Small and Medium-Sized Enterprises in the EU A Useful Tool for European Businesses or a Risk for Abusive Practices' (Master's Thesis, Lund University, 2011) p 18 (here in after Vasil Milev)

<sup>11</sup> Taxation of Small and Medium Enterprises (International Tax Dialogue, background paper, 2007) p 23, <<http://www.itdweb.org/smeconference/documents/itd%20global%20conference%20-%20background%20paper.pdf>> accessed 28 May 2014 (here in after Taxation of Small and Medium Enterprises)

<sup>12</sup> European Commission, *Monitoring and Consultation on Smart Regulation for SME* (staff working document ,Brussels, 7.3.2013 SWD, 60 final, 2013), PP 36, 20,21

<sup>13</sup> HM Revenue and Custom Authority, *Understanding key problems for SMEs: Hidden Economy Levers, Ghosts and Moonlighters*, (Behavioral Evidence & Insight Team, Research report, May 2012) p 7 (here in after *Understanding key problems for SMEs*)

<sup>14</sup> European charter for small enterprises, Feira European Council, 19-20 June 2000, the 7<sup>th</sup> line of action

<sup>15</sup> Understanding key problems for SMEs, pp 6,7, 13

<sup>16</sup> Taxation of Small and Medium Enterprises, pp 19-20

<sup>17</sup> OECD/European Union, *Value-Added Taxes in Central and Eastern European Countries: A Comparative Survey and Evaluation*, (OECD Publishing 1998 ), p 143(here in after *Value-Added Taxes in Central and Eastern European Countries*)



number of the registered business and the number of rates applicable,<sup>18</sup> the collected revenue compared with the perception costs might be disproportional justifying different treatment of SMEs.

## 2.2. The definition of SMEs

The definition and importance of SMEs varies depending on the development of the country and various other policy considerations. As a result, there is no single definition of SMEs.<sup>19</sup> Since the definition of SMEs is not cast in iron stagnant, it needs to be updated in order to adjust thresholds based on inflation or other reasons, to promote micro enterprises, to improve access to capital, to promote innovation and improve access to R&D and even to take account of different relationships between enterprises.<sup>20</sup> Thus, there needs to be a regulation for defining which enterprises are SMEs. According to the OECD,

*‘The definition of SME and the size thresholds used by the OECD are those recommended by the European Commission. The Commission defines a medium-sized enterprise as a firm having less than 250 employees; a turnover inferior to EUR 50 million and a balance sheet below EUR 43 million. A small enterprise as having less than 50 employees and turnover; balance sheet of less than EUR 10 million. Micro enterprise as a firm with less than 10 employees and a balance sheet and turnover below EUR 2 million’.*<sup>21</sup>

Similarly, in the case of VAT, there needs to be a harmonized definition of SMEs to avoid inconsistent treatment of enterprise within the EU. This is especially true as Article 281 of the Directive declares that a special scheme is for ‘small enterprises’. It should be noted here that it is the objective small size of the enterprise based on which undertakings are labeled as small and not based the fact that their activities in a particular Member State are limited.<sup>22</sup> Furthermore, for the purpose of SME support schemes, the form of business incorporation does not matter in order to qualify to be considered an SME.<sup>23</sup> However, it might matter for VAT purpose as some laws explicitly exclude all physical persons from SMEs and only include a natural person. When it comes to the EU VAT, we do not find such explicit exclusion of legal persons from the special treatment. However, Article 281 and 283(2) of the Directive could be interpreted to suggest that the application of the special scheme is only on natural persons. It is submitted here that it is the weak structure and lack of resource of SMEs that makes the application of VAT on SMEs to be difficult. On the other hand, legal persons have different duties that oblige them to keep books and recordings such as for reporting their financial position to their shareholders. Further, legal persons

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<sup>18</sup> *Value-Added Taxes in Central and Eastern European Countries*, p 141

<sup>19</sup> OECD, *Taxation of SMEs: Key Issues and Policy Considerations*, (Tax Policy Studies, No. 18, 2009) p23 (here in after *Key Issues and Policy Considerations*)

<sup>20</sup> *The New SME Definition User Guide*, pp 8-11

<sup>21</sup> *Key Issues and Policy Considerations*, p 23

<sup>22</sup> Opinion of AG Sharpston in Case *Commission v Austria*, C-128/05, EU:C:2006:263 as cited on Ben Terra & Julie Kajus, Commentary

<sup>23</sup> European Commission’s Recommendation concerning the definition of micro, small and medium-sized enterprises, (OJEU, L 124/36, 2003/361/EC) Recital 3 and (here in after Commission’s Recommendation concerning micro, small and medium enterprises); see also The definition of micro, small and medium-sized enterprises adopted by the Commission, (OJ L 124/40, 20.05.2003, Annex on Commission’s Recommendation concerning micro, small and medium enterprises) Art 1; *The New SME Definition User Guide*, page 12

are in a better financial position compared with natural persons as most legal persons have the ability to be established by mobilizing resource from different shareholders. Therefore, it can be argued that, the legal persons are excluded from the special scheme because the difficulties envisaged under Article 281 and 283(2) of the current Directive are less likely to be present. However, of course this can only be reached through purposive interpretation. Furthermore, even if for other purposes, such as state aid, SMEs are defined based on staff headcount, annual turnover and annual balance sheet,<sup>24</sup> the prevalent definition of SMEs for VAT purposes are annual turnover and payable VAT.

### 2.2.1 A definition based on annual turnover

Small businesses are exempted from registering under the normal VAT arrangement based on annual turnover. This objectively small business has an annual turnover below certain thresholds. The annual turnover limit could be similar for all business or different depending on the type of the businesses.<sup>25</sup> There are differences among Member States in setting this threshold. For example, businesses with less than £61,000 (US\$119,525) of annual turnover are considered to be SMEs and are not required to register for VAT in the UK while in Denmark the threshold is set at DKK 50,000 (US\$8,720).<sup>26</sup> Setting the threshold defining SME has both advantages and disadvantages. A higher threshold increases the ability for business that do not need to register for VAT to save administrative costs whereas it might, at the same time, result in revenue loss and tax discrimination between taxed and exempted business.<sup>27</sup>

Article 282 of the Directive stipulates that, the exemptions and graduated tax relief are applicable to the supply of goods and services by small enterprises; in addition, there are several articles that explain which enterprises can be considered 'small'. The turnover limit is set based on three categories of countries.

The first set of countries is by those Member States, which did not exercise the option under Article 14 of Directive 67/228/EEC.<sup>28</sup> For the purpose of these countries, small businesses are understood to be taxable persons whose annual turnover is no higher than EUR 5,000 or the equivalent in national currency.<sup>29</sup>

The next set of countries is formed by those Member States which, at 17 May 1977, were already exempting taxable persons whose annual turnover was equal to or higher than the equivalent in national currency of 5,000 European units of account at the then applicable conversion rate. These countries are, permitted to raise the ceiling in order to maintain the value of the exemption in real terms.<sup>30</sup> Thus, for these countries small business might have a higher threshold than the first set of countries. The last set of countries is those Member States, which acceded after 1 January 1978.<sup>31</sup> These states are given individual threshold limits ranging from 10,000 up to 35,000 ECU.

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<sup>24</sup> Commission's Recommendation concerning micro, small and medium enterprises, Recital 2, Art 2

<sup>25</sup> *Key Issues and Policy Considerations*, P 121

<sup>26</sup> Alfons j. Weichenrieder, (revised), *Survey on the Taxation of Small and Medium-Sized Enterprises*,( OECD publishing, 25 September 2007), P 13(here in after Alfons j. Weichenrieder)

<sup>27</sup> Alfons j. Weichenrieder, P 13

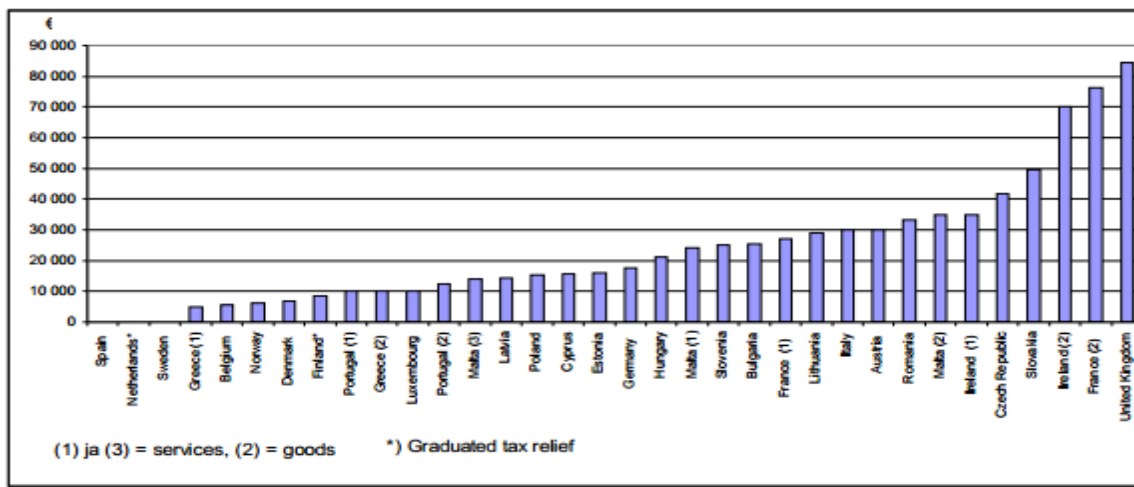
<sup>28</sup> Council Directive 2006/112/EC, Art 285

<sup>29</sup> Council Directive 2006/112/EC, Art 285

<sup>30</sup> Council Directive 2006/112/EC, Art 286

<sup>31</sup> Council Directive 2006/112/EC , Art 287

Table .. “The VAT registration thresholds in EU Member States and Norway in 2008 (source: EC).”<sup>32</sup>



According to Article 288 of the Directive the turnover, which serves as a reference for the purpose of applying the small business regime consists of the following, amounts, exclusive of VAT and disposals of the tangible or intangible capital assets of an enterprise:

1. *“The supplies of goods and services, in so far as they are taxed;*
2. *The value of transactions which are exempt, with deduction of the VAT paid at the preceding stage*
3. *The value of transactions which are exempt pursuant to Articles 146 to 149 and Articles 151, 152 or 153; and*
4. *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.”*

From the above stated articles and table it can be derived that even within the EU VAT there is no uniform definition of SMEs. This, on the one hand can be appreciated for the flexibility it gives Member States in defining SMEs, according the country’s situation of compliance burdens and attitude towards the loss of revenue, however it can, on the other hand, be problematic from the perspective of similar and uniform treatment of SMEs in the different Member States. Even if the SME is known to be less mobile, this different treatment could pave the way for tax planning of those businesses who wish to be exempted from VAT to go and establish in the Member States with higher exemption threshold.

### 2.2.2. A definition based on payable VAT

Although not prevalent as the definitions based on turnover, the other method used for defining SMEs in order to exempt them from VAT or extend to them simplification arrangements is the VAT payable. A special scheme based on turnover might be considered unfair, as it might not

<sup>32</sup> Takis Venetoklis and Timo Rauhanen, ‘Graduated tax relief system of VAT in Finland’ (2008) Government Institute for Economic Research , VATT/TRA, p 2

always represent the economic ability of the business included in the scheme. For example, Denmark has a standard rate of 25%. Thus, if the turnover is, for example, just 100,000 DKK, the payable amount might not be that significant. However, if there would be a reduced rate applicable, for example of 5%, for 25,000 DKK payable VAT the turnover amount will be five times bigger (assuming there is no input tax incurred). Furthermore, fixing general turnover has limitations, as the ability of one sector of business might be different from the other resulting in different incomparable businesses falling within the special scheme.<sup>33</sup> For this reason, the due payable VAT, which is more closely connected with the value added, is argued to be a better base than turnover.<sup>34</sup>

However, the definition based on turnover prevails perhaps because the definition based on payable VAT undermines some of the purpose of the special treatment as discussed under section 2.1 of this thesis for the reason that;

*“It obliges small businesses to keep accounts recording the VAT deductible on purchases and the VAT invoiced on receipts and, at the same time, require the authorities to make the calculations necessary to determine the net tax: however, if this is below the exemption ceiling it is not recovered.”<sup>35</sup>*

Therefore, although the current Directive bases the treatment as SME on turnover; it was agreed at the time of the adoption of Sixth Directive that Member States such as the Netherlands, which used to exempt based on payable VAT could retain their practice.<sup>36</sup>

### 2.3. Main characterizations of the special scheme that requires special attention

The first thing that needs to be noted is that the EU, VAT does not impose mandatory special treatment of small business on Member States. Only those Member States that believe special treatment should be extended to SMEs have adopted this scheme.<sup>37</sup> Furthermore, not all small businesses that fulfill the definition based on payable VAT or thresholds are included in this scheme. Art 283 of the Directive excludes;

- a) *“Transactions carried out on an occasional basis; as referred to in Article 12;*
- b) *Supplies of new means of transport carried out in accordance with the conditions specified in Article 138 (1) and (2) (a);*
- c) *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 and*
- d) *Other transactions the Member States wish to exclude.”*

Keeping this in mind, the other features of the special scheme in EU VAT will be discussed below.

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<sup>33</sup> Ben Terra & Julie Kajus, Commentary

<sup>34</sup> Ben Terra & Julie Kajus, Commentary

<sup>35</sup> Commission of the European Communities, *Description, Analysis and Suggestions for the Harmonization of National Schemes for Small Undertakings* ( report from the Commission to the Council, Brussels, 15 December 1983) p 25 (here in after *Description, Analysis and Suggestions for the Harmonization of National Schemes for Small Undertakings*)

<sup>36</sup> Terra Ben & Kajus Julie, *A guide to the European VAT Directives* (IBFD, 2013, Volume 1), p 25( here in after Terra Ben & Kajus Julie )

<sup>37</sup> Council Directive 2006/112/EC Art ,281

### 2.3.1. Input VAT deduction and opting for registration

Small enterprises in EU VAT that are covered by the special scheme for SME are not eligible to claim an input VAT deduction or show VAT in their invoice.<sup>38</sup> However, the Directive allows the option for registration to those businesses who believe themselves, to be better off under the normal VAT arrangement or simplified procedures.<sup>39</sup>

Therefore, small businesses whose customers are mainly registered taxable persons with the right to deduct their input VAT might opt to register. On the other hand, those small businesses whose main supplies are to end users might prefer to stay VAT exempted in order to attract customers with a VAT exclusive price. It is not clear under article 290 of the Directive if small business can claim the option to register as of right or a privilege. In the writers view the option to register should be considered as a privilege because the sentence in Article 281 which begins by stating “Member States, which might encounter difficulties in applying the normal VAT arrangements to small enterprises..” shows that the consideration is not just the wish of a small business. Furthermore, as discussed under section 2.1 of this paper, special treatment of SMEs is also for the benefit of the tax authority. Moreover, since taxable persons are delegated to collect VAT on behalf of the tax authorities, the delegation should not be forced if the authorities do not believe the SMEs are able to handle it. Thus, tax authorities might reject the small business opting for VAT registration if it is believed to become more burdensome to the tax authority or the business at issue is incompetent to overcome the responsibility.

### 2.3.2. Intra-Community supply and acquisition of goods by SMEs

Notwithstanding that, Article 281 of the Directive stipulates that, it is a simplification procedure the scheme is sometimes complicated.<sup>40</sup> This is especially true in regards to intra- Community acquisition and supply of goods made by exempted small business.

Intra-Community acquisition of good made by small traders covered by a special scheme might be a burdensome transaction because of Article 2(1)(b)(I). This article stipulates that intra Community acquisition of goods by traders covered by the special scheme for small traders is not subject to VAT. As a result, if the vendor is covered by the special scheme, the supplies will be exempted without the right to deduct resulting in the absence of intra-Community acquisition of goods by the buyer.<sup>41</sup> This might become difficult for the recipient, as it might be unclear if the exemption is the result of supply made by small enterprise or because of the exemption for intra Community acquisition of goods under Article 138.<sup>42</sup> However, the above does not apply for the supply of new means of transport which is excluded from the scheme under Article 283(1)(b).<sup>43</sup>

On the other hand, the intra Community acquisition of goods by a small business can be understood to be covered by Article 3(1)(b) of the Directive. As already discussed above, supplies

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<sup>38</sup> Council Directive 2006/112/EC Art , 289

<sup>39</sup> Council Directive 2006/112/EC Art 290, 281

<sup>40</sup> William Turnier, ‘Small businesses under a VAT’, IVM 1994/6, p. 333 as cited on Ben Terra & Julie Kajus, Commentary

<sup>41</sup> Ben Terra & Julie Kajus, p. 410

<sup>42</sup> Ben Terra & Julie Kajus, p. 410, footnote 487

<sup>43</sup> Ben Terra & Julie Kajus, p. 410

by small businesses is exempted without the right to deduct both in domestic and intra-Community transactions.<sup>44</sup> Thus, small business covered by the scheme fall within the sentence under Article 3(1)(b) referring to "...a taxable person who carries out only supplies of goods or services in respect of which VAT is not deductible...".<sup>45</sup> As a result, the intra-Community acquisition by a small business is not subject to VAT as long as the threshold set in accordance with Article 3(2)(a) is not exceeded. Another aspect that needs consideration is the choice of thresholds between the normal threshold applied in accordance the provisions of the special scheme or the threshold in accordance with Article 3. For example, the threshold for exemption in those Member States which have not exercised the option under Article 14 of Directive 67/228/EEC, is an annual turnover less than EUR 5,000.<sup>46</sup> On the other hand, Article 3(2)(a) of the Directive stipulates that the threshold set may not be less than EUR 10 000. Thus, the two Articles might be difficult to reconcile and apply by these member states. *Ben Terra* and *Julie Kajus*, by assuming that the second threshold should not influence the first, conclude that in the event the general threshold is exceeded, the intra-Community acquisition of goods by the small business will be subject to the normal arrangement even if the threshold fixed in accordance with Article 3(2)(a) is not yet exceeded.<sup>47</sup>

It was decided in the *Ingrid Schmelz* case that the scheme could be benefitted only in the Member State of registration.<sup>48</sup> Thus, the other issue that further complicates intra Community acquisition made by small business is that they need to register for VAT if they are not covered by the derogation under Article Art. 3(1)(b). This case brings an additional cost of registration in Member States where the transaction is done less frequently.<sup>49</sup> Therefore, this requirement for registration is not consistent with the purpose of the exemption of small and medium enterprise from VAT in the first place.

### **3. CHAPTER THREE: RELEVANT ISSUES FOR CONSIDERATION IN THE SPECIAL SCHEME**

In the previous chapter, the special scheme for small undertakings has been explained briefly. From the discussion, it can be derived that, the definition of SMEs is not harmonized in the different Member States. Furthermore, although small undertakings can opt for registration, the deduction of input VAT is denied as long as they are exempted. Moreover, small businesses could enjoy the scheme only in the state of registration. Under this chapter, the possible consequences of these rules will be examined. In particular, the VAT cascading consequence of denying input VAT deduction, the effect of the special treatment of SMEs on competitive neutrality, and the efficiency of the scheme will be analyzed in detail.

#### **3.1 Input VAT deduction and VAT cascading**

Social, economic and cultural human rights have core contents that may not be infringed in whatever form for whatever justification. Although VAT system is not an economic human right, the writer believes deduction of input VAT is the core content of VAT that should not be tampered

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<sup>44</sup> Ben Terra & Julie Kajus, Commentary

<sup>45</sup> Ben Terra & Julie Kajus, Commentary

<sup>46</sup> Council Directive 2006/112/EC Art , Art 285

<sup>47</sup> Ben Terra & Julie Kajus, Commentary

<sup>48</sup> Judgment in *Schmelz*, C-97/09, EU:C:2010:632, para 72, 77

<sup>49</sup> Vasil Milev, p 28



with. While some may claim that, deduction of input VAT is a right inherent to the system of VAT other may argue it is only a privilege extended as long as the law allows it. Whatever the case, the paradox of VAT is clearly manifested in the current exemption trend of SMEs in the EU VAT.

One of the reasons for adopting the harmonized VAT in EU is the need to avoid a multiple stage cumulative sales tax.<sup>50</sup> The special feature of VAT, unlike other sales tax, is that it is neutral towards traders<sup>51</sup> in terms of avoiding the cascading of tax through the deduction of input VAT. Similarly, European VAT, is meant to target end consumers.<sup>52</sup> Hence, it is submitted that the core aspect of VAT is the right to deduct. The right to deduct input VAT, as long as the input is used for the purpose of the taxable person's business, is enshrined under Article 168 of the Directive.<sup>53</sup> However, this right is denied to small business under the special scheme even if the input is for the purpose of the taxable person's business. This is also true for intra Community acquisition of goods that results in a hidden tax burden of the Member State from where the good was intra-Community supplied.<sup>54</sup> Thus, in both domestic and intra-Community transactions, the exemption without the right to deduct result in the cascading of the tax.

Normally, all tax carries both direct and indirect costs.<sup>55</sup> The direct cost relates to paying the tax at hand whereas the indirect cost is related to administration cost of the tax. When we see the concept of VAT, it is only supposed to burden the taxable persons with indirect cost, meaning administrative cost. Hence, VAT intends to impose the direct cost on consumers. Therefore, in order to remove a VAT as a business cost from the price, taxable person need to be refunded input VAT properly.<sup>56</sup> However, this is not true for SMEs covered by the special scheme. As we have seen under section 2.3.1 of this thesis, taxable persons exempted from registering for VAT can neither deduct input tax nor show the VAT on their invoice. This means SMEs have to find another way to recover the input VAT they paid. As a result, the SMEs that are denied the ability to deduct the input tax will calculate, as part of their selling price, the VAT paid when purchasing the input for the goods or service they provide. This will have an adverse effect on the legal characterization of the indirect tax VAT, by hindering the chance of shifting the tax forward. This problem is intensified if the exempted small business is supplying to VAT registered taxable person with the right to deduct as described in the example underneath.<sup>57</sup>

	<b>Sales</b>	<b>Tax on sales</b>	<b>To treasury</b>
Soap factory	1,000	100	100
Cleaning business	2,100	exempt	
Factory	3,100	310	310
Wholesaler	4,100	410	100
Retailer	5,100	510	100
			<b>Total 610</b>

<sup>50</sup> First Council Directive 67/227/EEC, fourth recital

<sup>51</sup> Iain Charlet and Stéphane Buydens, 'The OECD's Draft Guidelines on Neutrality for Value Added Taxes' (2011) Volume 61, Number 6, Tax Notes Int'l, p. 444 (here in after OECD's Draft Guidelines on Neutrality)

<sup>52</sup> Oskar Henkow 'Neutrality of VAT for Taxable Persons'(2008), 5/2008, EC Tax Review, p 233

<sup>53</sup> OECD, *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administration Issues*, (OECD Publishing, 2012) P 16

<sup>54</sup> Council Directive 2006/112/EC, Art 139; Ben Terra & Julie Kajus, p 410

<sup>55</sup> Cnossen, Sijbren 'Administrative and Compliance Costs of the VAT: A Review of the Evidence' (1994) vol. 63, Tax Notes ; J. A. Kay, 'tax policy: a survey' (1990) Vol. 100 No. 399, The Economic Journal, pp. 60,61

<sup>56</sup> Alan Schenk, *Value Added Tax: A Comparative Approach* (Cambridge University Press, 1991) p 41

<sup>57</sup> The example is taken with some modification from Ben Terra & Julie Kajus, pp 273- 274

In the above example since the cost price has gone up with 10%, 10 has become cumulated tax distorting the taxing of only the value added at each stage of production.<sup>58</sup> Thus, the involvement of an exempted small business has broken the chain of credit resulting in a cascade the same way as other retail sales tax does.<sup>59</sup> Hence, the problem of VAT cascading disturbs the very essence of VAT by undermining the mission to tax only the value added at each stage. Allowing SMEs to opt for registration and the fact that SMEs are usually at the end of the supply chain, may reduce the alarm in this problem. However, it does not solve the problem completely because extending the option for registration is not going to change the fact that SMEs are in a difficult position to overcome the compliance costs of VAT. Furthermore, the supply of SMEs to taxable persons, instead of only to consumers, needs to be encouraged for reasons such as facilitating their transformation into larger companies. This is because end consumers purchase limited products by making small business profit always hand to mouth. However, taxable persons have the tendency to purchase in mass by facilitating the cash flow advantage of the SMEs to enlarge their business. Even in the event that the SMEs are not able to supply in bulk for many companies, supplying all its products for one registered company might be efficient and cost effective instead of supplying for many nontaxable persons over a long period. This is particularly important since SMEs have limited access to debt or equity financing confining them to rely on their profit for the extension of their business.<sup>60</sup> Therefore, if VAT should not burden small business, it should not also burden them with non-deductible input VAT.

For the reasons discussed above, the writer of this paper considers the exemption without deduction as an “abomination” to the key special features of VAT. Instead, making the exemption with the right to deduct (zero rating) might resolve these problems.<sup>61</sup> However, since the zero rating of the exemption might result in the deficiency of the own resource due to the Union, the Member States might need to provide subsidy in their attempt to cover the tax rate expected from them.<sup>62</sup> For this reason, some or all Member States might not favor zero-rating the exemption. Thus, it comes to the question how far EU and its individual Member States are willing to go in order to utilize its small business that are 90% of all business operating in its jurisdiction and often referred as the backbone of its economy. If the answer is to extend the exemption to zero-rating, the required step will be amending Article 289 of the Directive, as zero rating could be implemented only in the event it is specifically granted in the Directive.<sup>63</sup>

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<sup>58</sup> Ben Terra & Julie Kajus, p 274

<sup>59</sup> The Congress of the United States, *Effects of adopting a value-added tax* (The Congress of the United States Congressional Budget Office study, 1992) pp 28-29 (here in after *Effects of adopting a value-added tax* )

<sup>60</sup> Taxation of Small and Medium Enterprises, p 11

<sup>61</sup> John F. Due, ‘some unresolved issues in design and implementation of value added taxes’ (1990) Vol. 43, No. 4, National Tax Journal, p 385

<sup>62</sup> Ben Terra & Julie Kajus, 2013, p 695

<sup>63</sup> Judgment in *Commission v United Kingdom*, C- 416/85, EU:C:1988:321 para 44; Judgment in *Commission v Ireland*, Case 415/85 EU:C:1988:320, para 37



### 3.2 Neutrality and fair competitions

Neutrality is a relative matter, which can be discussed only from a perspective.<sup>64</sup> Hence in this section the neutrality of the special scheme for SMEs from competitive neutrality (fair competition) point of view will be discussed. Competitive neutrality can be explained as,

*“Competitive neutrality is a principle that promotes the equal treatment by governments of competing organizations to achieve a ‘level playing field’....The violation of competitive neutrality is only distortionary where government policy provides a systematic advantage to some organizations over others competing in the same market. One provider should not receive an advantage over another due to government regulation, subsidies or tax concessions”*<sup>65</sup>

The first Council Directive 67/227/EEC stipulates that the objective of the Treaty is to establish a common market within which there is healthy competition with similar characterization of the domestic market.<sup>66</sup> It further stipulates that it aim to create a value added tax at all stages that assure most simplicity and neutrality in a way that does not distort conditions of competition and free movement of goods and service within the Community.<sup>67</sup> It also states that a highest degree of neutrality can only be achieved when its scope covers all stage of production (a broad base tax).<sup>68</sup> This same notion of neutrality is also present under the current VAT Directive. As a result, it states that replacing of the previous turnover tax practices of the Member State by harmonization of VAT is necessary in order to achieve these objectives.<sup>69</sup> Following this, all Member States have VAT similar to each other. However, despite these clear objectives for harmonization of VAT for neutrality purpose, optional schemes that undermine uniformity, such as a special scheme for small undertakings are also enshrined in the VAT Directives of both past and current.

It was the intention of the legislator that similar goods bear the same tax burden.<sup>70</sup> However, in the current VAT, similar goods and service bear different burdens depending on the size of the taxable person. Since normally VAT is neutral for taxable persons, the burden of the direct cost of paying VAT should not fall on them.<sup>71</sup> However, it was explained in the previous section this is not the case for a small business covered by the scheme that applies an exemption without the right to deduct. Therefore, the consequence of this for fair competition is the obvious shown in the example below.<sup>72</sup>

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<sup>64</sup> Ben Terra & Julie Kajus, PP 71-78

<sup>65</sup> Competitive neutrality issues, [http://www.pc.gov.au/data/assets/pdf\\_file/0003/94566/12-chapter8.pdf](http://www.pc.gov.au/data/assets/pdf_file/0003/94566/12-chapter8.pdf), page 192.

Even if this definition is given in an individual domestic country context, the writer believes it is comprehensive enough to be used in EU wide for achieving the internal market, as domestic government of the member states will eventually implement EU laws and policy that might affect competitive neutrality.

<sup>66</sup> First Council Directive 67/227/EEC, first recital

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

<sup>68</sup> First Council Directive 67/227/EEC, fifth recital

<sup>69</sup> First Council Directive 67/227/EEC, third recital

<sup>70</sup> First Council Directive 67/227/EEC, seventh recital

<sup>71</sup> Alain Charlet and Stephane Buydens, ‘VAT and GST Refunds, Towards more business - friendly mechanisms?’ (2009) the tax journal, 9 March, p 21

<sup>72</sup> Example taken from Vasil Milev, p 19

<i>SMEs covered by the exemption scheme:</i>	<i>A registered taxable person</i>
<i>Input materials, electricity, etc. 1,000 units</i> <i>VAT paid + 200 units</i> <i>VAT deducted - 0 units</i> <i>Value added + 1,000 units</i> <i>VAT charged + 0 units</i> <i>Final price 2,200 unit</i>	<i>Input materials, electricity, etc. 1,000 units</i> <i>VAT paid + 200 units</i> <i>VAT deducted - 200 units</i> <i>Value added + 1,000 units</i> <i>VAT charged + 400 units</i> <i>Final price 2,400 units</i>

From the above example, it is obvious that all other things being equal a customer (non-taxable person) will rather pay 2200 than 2400 for the same product. Thus, even if as mentioned earlier it is clearly envisaged in the recitals of the VAT Directives the tax should not bring distortion of fair competition, it is clear that if the targets of both businesses are end users, it has a competitive advantage for small business and disadvantage for larger registered business that cannot opt to be exempted.<sup>73</sup> Even in the event the exempted SMEs decide to set the price similar with those enterprises that charge VAT, SMEs are still benefiting because the VAT will act as a subsidy to SMEs in this case.<sup>74</sup> Furthermore, the price difference might even be higher than the example because the registered business will need to include in its price some part of compliance cost of VAT while the exempted business do not incur it at all. Nevertheless, registered businesses have a competitive advantage when it comes to trading with other business with the right to deduct. However, this is not an absolute competitive advantage like the one discussed above because small business can opt to register, albeit not per transaction or per category of customers.

The issue of fair competition is also relevant from the perspective of freedom of establishment and abusive practices. This could be understood from settled cases law in which the Court reflected that the mere fact of establishing in another lower tax jurisdiction do not constitute an abusive practice by itself.<sup>75</sup> This is because the absence of harmonization of corporate taxation grants the businessperson to choose the most beneficial regulatory regime and as long as the Member States do not agree to harmonize, they should not overstretch abusive practice to prevent their capital from moving out and going to a lower tax rate states for EU competitiveness.<sup>76</sup> Similarly, the optional nature of the scheme makes this also true for the VAT treatment of small business despite the harmonization of VAT. For example, Sweden does not have special schemes for small enterprise; however, UK has the scheme with very large turnover limitation. Hence, a business that wishes to be exempted because it is targeting mainly end consumer may prefer to establish in the UK. Even if small businesses are known to be less mobile, it is still a distortion of fair competition and building single market in the EU. Further, “VAT systems should be applied in such a way to ensure that there is no unfair competitive advantage awarded to domestic businesses.”<sup>77</sup> However, the precondition that SME can only be covered with the scheme in their state of registration<sup>78</sup>

<sup>73</sup> Rita de la Feria and Richard Krever, *Ending VAT Exemptions: Towards A Post-Modern VAT* (Oxford University Centre for Business Taxation, WP 12/28, 2012) p 11 (here in after *Ending VAT Exemptions*)

<sup>74</sup> *Taxation of Small and Medium Enterprises*, P.9

<sup>75</sup> Judgment in *Centros*, C-212/97, EU:C:1999:126, Para 27, 39

<sup>76</sup> Rita de la Feria, *Prohibition of Abuse of (Community) Law – The Creation of a New General Principle of EC Law Through Tax?* (Oxford university center for business taxations, park end street oxford ox1 1HPWP 07/23,2007) p 14,34,35

<sup>77</sup> OECD’s Draft Guidelines on Neutrality, p 446

<sup>78</sup> Judgment in *Schmelz*, C-97/09, EU:C:2010:632, para 72,77

brings additional cost on small business already registered in other Member States and gives the domestic small business a competitive advantage.

Furthermore, even among those states that have adopted the scheme, there is a big difference in the turnover definition of SMEs. The proposal for the new definition of SMEs stipulates;

*“...the application of the same definition by the Commission, the Member States, the European Investment Bank (EIB) and the European Investment Fund (EIF) would improve the consistency and effectiveness of policies targeting SMEs and would, therefore, limit the risk of distortion of competition”.*<sup>79</sup>

The writer believes this could be beneficial in the sphere of VAT as well, if it could be extended to the VAT Directive. The risk of distortion of competition created by the special scheme can be limited if Member States could reconcile and compromise their benefits in order to agree on uniform definition of SMEs.

The justification ground for these above problems could be a need for "positive discrimination" to balance the disadvantages that small enterprises have compared to large businesses.<sup>80</sup> Further, a competition aspect of neutrality is not just a matter of economics, but legal and political formulated based on the intention of the legislator.<sup>81</sup> For instance in the case of *Zimmermann*, the CJEU by taking a more positivists approach, decided that the exemptions provided by the Directive cannot be challenged based on the principle of fiscal neutrality.<sup>82</sup> Following the approach of the Court in this case, if the VAT Directive stipulates different treatment for SMEs, then it can be concluded that it is neutral despite the economic reality, or at least is not breaching the fiscal neutrality requirement. This is consistent with the different issues that resulted in different treatment of SMEs from large enterprises and even in different treatment of who should be covered by the scheme based on in which country it is located. It becomes clear that neutrality is also a political issue just as the law is. As a result, despite the proposal of the Commission that recommends, “an exemption scheme, which inevitably creates distortions of competition and problems of residual tax, should be retained only in order to eliminate small files...”<sup>83</sup>, exemption schemes with very high threshold still exists for different other reasons. For example, the different political need for convincing EU citizens to welcoming VAT has resulted in different compromises reflected in the exemption of some supplies.<sup>84</sup> For instance, to respect neutrality in Denmark emphasis was given to equal treatment of all business with a little adjustment of exempting very small enterprises with a very low threshold,<sup>85</sup> whereas in UK emphasis was given to other priorities. This, just like the issues of transfer pricing and State aid in VAT, might be hard to swallow for economists that advocate neutrality and fair competition from a pure economics point of view. However, even if legal neutrality is also undermined when identical goods are taxed

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<sup>79</sup> Commission’s Recommendation concerning micro, small and medium enterprises, first recital

<sup>80</sup> *Description, Analysis and Suggestions for the Harmonization of National Schemes for Small Undertakings*, p 39

<sup>81</sup> Ben Terra & Julie Kajus, p 251

<sup>82</sup> Judgment in *Zimmermann*, C-174/11, EU:C:2012:2449, Para 44,46,50,55

<sup>83</sup> Commission of the European Communities, *Description, analysis and suggestions for the harmonization of national schemes for small undertakings* (report from the Commission to the Council Brussels, 15 December 1983) p 19

<sup>84</sup> Ending VAT Exemptions, p 6

<sup>85</sup> Alan A.Tait, *Value Added Tax: International Practice and Problems* (International Monetary Fund, Jun 15, 1988) p 122 ( here in after Alan A.Tait )

differently,<sup>86</sup> legal neutrality also respects the need to ensure only equals are taxed and burdened equally.<sup>87</sup>

### 3.3 Efficiency of the special treatment of SMEs

According to Adam Smith, tax has to be fair (in light of equality), certain and convenient with economical cost of collection.<sup>88</sup> As a result, these four principles have been preached to be a guideline in the designing of tax laws.<sup>89</sup> Thus, a tax system that balances the above principles can be considered efficient. In this section, the efficiency of the scheme will be examined from the perspective of its effect on taxpayer's behavior and contributions to the essence of VAT.

An efficient tax system is a tax system that influences our behavior as little as possible and is not a factor influencing person's behavior.<sup>90</sup> In light of the above statement, it is important to study the effect of tax on behavior because one cost of the tax is changing the behavior of the taxpayer and reducing satisfaction and happiness by resorting to their secondary choice.<sup>91</sup>

The current exemption of SMEs influences the behavior of both consumers and traders in the scheme. A taxable person who normally would have preferred to do a transaction with the exempted small business may resort to its secondary choice just to skip the encumbrances of non-deductible VAT. Similarly, the end consumer who normally prefers to transact with registered taxable person might resort to its secondary choices of exempted small enterprise to avoid the VAT. In countries where only natural persons are permitted to fall within the scheme, it might even influence the choice of form of registration. Therefore, even if consumption taxes are known to be more efficient with less effect on behavior, the special exemption of small business without the right to deduct puts this under question by influencing both the behavior of taxable persons and end consumers.

Research indicates that the VAT system will be more efficient if its base is broadened by removing exemptions.<sup>92</sup> However, the above argument should not be conclusive for the supporting arguments that contend it's more efficient if SMEs are included under the normal VAT arrangement. This is because, if a small business is subject under the normal arrangement to avoid the above problems, it will still be inefficient if the subjection under the normal arrangement will result in the excessive burden of the VAT compliance cost of a small business encouraging closing of their business. Further, the inability to survive legally might also compel small business to resort to transact in the informal economy. This again has an effect on the behavior of the taxable person as the businessperson who would have normally preferred to perform his business legally may

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<sup>86</sup> Ben Terra & Julie Kajus , pp 255, 251

<sup>87</sup> Ben Terra & Julie Kajus, p 250; Opinion of AG La Pergola in *Goldsmiths v Commissioners of Customs & Excise* C-330/95, EU:C:1997:94, para 19

<sup>88</sup> Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Jim Manis, Ed, The Pennsylvania State University, in an electronic classics series publication PSU-Hazleton, PA 18202, first published in 1976, 2005) pp 676-678

<sup>89</sup> David Williams, *Value-Added Tax, Tax Law Design and Drafting* (Victor Thuronyi ed ,volume 1; International Monetary Fund: 1996.) pp 5-18

<sup>90</sup> Johnathan Skinner, Do Taxes Matter? (A Review of the Effect of Taxation on Economic Behavior and Output, The World Bank working paper WPS 48, PPR Dissemination Center, August 1989), pp 4-9; Nikulina Svetlana Gen, Costs of Taxation, May 7, 2012, <<http://www.9articles.org/costs-of-taxation/>> accessed on 25 May 2014

<sup>91</sup> *ibid*

<sup>92</sup> *Consumption Tax Trends 2012*, p58

resort to illegal methods. Therefore, both registration and exemption without the right to deduct have an effect on behavior that will shadow the efficiency of the system. As a result, in light of efficiency, zero rating of the transaction seems to be more desirable.

Furthermore, the writer believes an efficient tax system should be able to implement the tax at issue in accordance to its main essence. In light of this, one needs to understand the legal (who is legally responsible for the tax) and economic (the change in the distribution of real income) incidence for tax shifting.<sup>93</sup> Even if the legal incidence of VAT falls on the taxable person and the real economic incidence is on the person who makes the consumptive expenditure, this is not the case for small enterprises covered by the scheme. Of course, it might be argued that, even in this case, the real economic incidence is on the person who made the consumptive expenditure because the small enterprise has added the non-deducted input VAT on the price for the transaction. However, this argument will have been accepted only if the discussion was on profit tax and not VAT. Therefore, the exemption of the scheme undermines the implementation of the scheme according to its essence.

Furthermore, even if, by avoiding exemptions,<sup>94</sup> taxing the less mobile small business that does not have several choices seems to be efficient, the issue of fairness and ‘vertical equity’<sup>95</sup> can be invoked to advocate that small business should only be subject to the compliance burden they can overcome. Similarly, administrative simplicity can also go both ways. It is not effective for the tax authority to spend a lot of energy on small business with a minimum contribution for the revenue,

*“In fact, bringing every small business into the VAT system increases administrative costs exponentially, and the additional VAT collected may be largely absorbed as costs in collecting the tax. Therefore, even if some revenue is forgone by dropping small taxpayers, in most countries any revenue loss could be likely recouped by removing the high administration costs of assessing numerous low-return taxpayers who universally account for relatively few VAT revenue”*<sup>96</sup>

At the same time, since the EU VAT has already been criticized for having multiple rates that undermine the efficiency of the tax,<sup>97</sup> it can be argued taxing everybody, in the same way will facilitate the administrative simplicity by minimizing the expenditure on the administration of different rates and schemes.

Whatever the case, it cannot be ignored that just as other exemptions; the current special scheme for small enterprise is undermining the economic neutrality and efficiency of the tax.<sup>98</sup> Thus the question remains, is it worth it or are there other possible approaches.

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<sup>93</sup> Rosen, H and T. Gayer, *Public Finance* (8<sup>th</sup> ed, Mc Graw-Hill, International Edition 2007), p 304

<sup>94</sup> *Consumption Tax Trends 2012*, p58

<sup>95</sup> Rita de la Feria and Richard Krever, *Ending VAT Exemptions: Towards A Post-Modern VAT*, Oxford University Centre for Business Taxation, WP 12/28, p 29

<sup>96</sup> M. Keen and J. Mintz, “The Optimal Threshold for Value-Added Tax” (2004) *Journal of Public Economics* 88, 559-576, as cited on Rita de la Feria and Richard Krever, *Ending VAT Exemptions: Towards A Post-Modern VAT*, Oxford University Centre for Business Taxation, WP 12/28

<sup>97</sup> *Effects of adopting a value-added tax*, P 14

<sup>98</sup> OECD, *Consumption Tax Trends 2010* (Paris: OECD Publishing, 2011, as cited at Rita de la Feria and Richard Krever, *Ending VAT Exemptions: Towards A Post-Modern VAT*, Oxford University Centre for Business Taxation, WP 12/28

## 4. CHAPTER FOUR: OTHER POSSIBLE APPROACHES TO THE TREATMENT OF SMEs

In the previous chapters, the current special treatment of small business in the EU VAT Directive and its main issues related to exemption without the right to deduct has been discussed. After reading some of the characteristics and shortcoming of the current exemption scheme, the next logical question that comes to mind is what other alternative treatments of SMEs are available. Therefore, under this chapter, other approaches that could be extended to small enterprise will be discussed divided into two parts. The first part consists of those that exempt small business but provides a special scheme (other than the general, special scheme for SMEs under the current VAT Directive). The second part consists, the ones that do not exempt small businesses from VAT, but simply extend special simplification procedures to SMEs to ease the burden of VAT on small business (simplification methods). These approaches will be discussed based on their ability to overcome the issues discussed under chapter three while at the same time maintain the need for special treatment of SMEs discussed under chapter two.

### 4.1 Special scheme (exempting business from the normal arrangement of VAT)

#### 4.1.1 The common flat rate scheme for farmers

Even if all SMEs might be faced with the burden of denial of input, VAT the Directive has extended special relief from this problem to farmers. The main difference between farmers and another SME is that other SME sell to final consumers while farmers sell to factories for further processing.<sup>99</sup> In other words, while most other SME are at the end of the supply chain, farmers are in the beginning. This means denial of input VAT deduction is not the only problem for the farmer, but also results in further successive accumulation by the business customer of the farmer or even worse loss of business customer for the farmers. Micro economically this might not be a big deal. However, macro-economically it will result in distortion of market competition with other farmers and food processing factories all over the world. Further, as VAT is designed as a tax on final private consumption, it must have a neutral effect on traders.<sup>100</sup> Thus, in order to relive taxable persons from the burden of VAT, flat rate compensation for the flat rate farmer (herein after FRF) and deduction of input VAT for the business customer is provided as a tool.

Therefore, the main purpose of the common flat rate scheme for farmers (herein after CFRSF) is to relive the FRF from the administrative burden in one hand and at the same time avoid VAT accumulation. The above purposes of the scheme are reflected in the functioning of the scheme discussed underneath.

#### 4.1.1 How does the CFRSF function to prevent VAT accumulation?

Hence, one purpose of the scheme is a simplification, the flat rate farmers do not need to register for VAT and acquire VAT identification number as pursuant to Article 272 (1) (e) of the Directive Member States are permitted to relieve such farmers from all or some of the obligations imposed

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<sup>99</sup> Ben Terra & Julie Kajus, Commentary

<sup>100</sup> Alexandre Mathis, *Taxation papers VAT indicators*, (European Commission Directorate-General Taxation & Customs Union, Working paper No /2004, ISSN 1725-7557, 2004), P 5; Opinion of AG Léger Case C-321/02 *Finanzamt Rendsbug v Detlev Harbs*, C:2004:142, Par 3

by the Directive on taxable persons. Further, the scheme while on the one hand protects the competitiveness of the farming market by allowing input recovery to farmers, on the other hand, also benefits the taxable person customer of the farmer to exercise the right to deduct unlike the business customers of SME. The writer will further discuss this underneath.

#### **4.1.1.1 Recovery of input VAT by the FRF**

A Member State who adopted this scheme has first to fix a certain flat rate compensation for the farmer and notify the EU Commission before implementing it.<sup>101</sup> This flat rate compensation is calculated based on the macro-economic analysis of flat rate farmers for the preceding three years meaning the ratio of the VAT input to output of agricultural products falling within the special scheme.<sup>102</sup> As this will result in the average despite the rule that dictates there should not be a refund greater than the input VAT charged to the farmers<sup>103</sup>, some farmers will lose, and others will benefit.<sup>104</sup> However, it should be noted that farmers can opt for the normal VAT if the flat rate compensation is disadvantageous as a result of incurring input greater than average.<sup>105</sup> For example, UK has set 4%<sup>106</sup>, Ireland 5.2%<sup>107</sup> and Germany has 5.5% for forestry products that are not the product of sawmill supplies and 10.7% for the rest.<sup>108</sup>

The flat-rate farmer will incur input VAT whenever she purchases input products such as seed, pest control or fertilizer from taxable person registered for VAT. In order to relieve the farmer from this input VAT she will be paid by the customer or the authority the flat rate compensation fixed by that Member State as per the calculation mentioned above.<sup>109</sup> As farmers are not expected to go through the normal deduction procedure, a flat-rate farmer just needs to make sure to add a flat rate addition when supplying agricultural products and service to taxable person registered for VAT and non-taxable legal persons registered in other Member States to discharge intra-Community transactions. The flat rate addition is not added on the FRF supply to nontaxable person or other FRF.<sup>110</sup> The FRF will keep this added percentage and do not account for VAT. After this, the FRF is prohibited from exercising the deduction right under the normal arrangement in addition to compensation to the flat rate.<sup>111</sup>

#### **4.1.1.2 Deduction of input VAT by taxable person customer of FRF**

Although, the flat rate addition on the price of the supply of agricultural products or services by the farmer is not strictly speaking VAT, it will be considered as if it is for deduction purpose of the

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<sup>101</sup> Council Directive 2006/112/EC, Articles 295(1)(7),297,298,299

<sup>102</sup> Alan A.Tait, p 142; Council Directive 2006/112/EC, Art 295(1)(7),297,298,299

<sup>103</sup> Council Directive 2006/112/EC, Art 299

<sup>104</sup> Alan A.Tait, p 144

<sup>105</sup> Council Directive 2006/112/EC Art 296(3)

<sup>106</sup> HM Revenue and Custom Authority 'Agricultural flat rate scheme' (Reference: Notice 700/46, October 2012) <[http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?nfpb=true&pageLabel=pageVAT\\_ShowContent&id=HMCE\\_CL\\_000078&propertyType=document#P18\\_1037](http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?nfpb=true&pageLabel=pageVAT_ShowContent&id=HMCE_CL_000078&propertyType=document#P18_1037)> accessed 15 May 2014 ( here in after HM Revenue and Custom Authority)

<sup>107</sup> Irish Tax and custom, 'Farmers and intra EU transaction' (VAT Interpretation Branch, Indirect Taxes Division, Dublin Castle, May 2010), <<http://www.revenue.ie/en/tax/vat/leaflets/farmers.html>>, accessed 15 May 2014

<sup>108</sup> KPMG 'Germany: VAT essentials' (Tax, Global Indirect Tax, Regulatory update, 6/1/2013) <<http://www.kpmg.com/global/en/issuesandinsights/articlespublications/vat-gst-essentials/pages/germany.aspx>> accessed 15 May 2014

<sup>109</sup> Council Directive 2006/112/EC, Art 300(1)

<sup>110</sup> Judgment in *Commission v. Italy*, Case 3/86, EU:C:1988:338, Para 21,22

<sup>111</sup> Council Directive 2006/112/EC, Art 302



business customer.<sup>112</sup> FRF does not have to account VAT or keep records of the receipts for input VAT deduction purposes. However, the business customers will need to keep the receipts and provide them to the tax authority for deducting the flat rate addition they paid to the flat rate farmer.<sup>113</sup> In Some countries like UK that allow Self-Billing, the customer can prepare an invoice for the FRF.<sup>114</sup> The taxable person under the normal deduction and refund procedures enshrined in the Directives will recover the flat rate addition paid by a taxable person to the farmer.<sup>115</sup>

#### 4.1.2 Drawbacks of the CFRSF

As discussed above this scheme mitigates VAT cumulation problems better than the exemption special scheme for SMEs. However, this is not without limitation. This scheme is only for farmers and other SMEs do not have the same privilege even if their supply might be for taxable persons. In addition, as noted under section 2.2 of this paper, even if normally small traders are defined based on turnover or payable VAT, this scheme defines farmers based on activities that can fall within the framework of agricultural production activities listed under annex VII and agricultural service listed under annex VIII. Even if it is, obvious that it is for small farmers the absence of specific threshold definition will further lead to deferent treatment of farmers in each Member State based on the specific Member State perception of what is small. This of course will lead to similar problems affecting harmonization, fair competition and neutrality similar with the general scheme for SMEs discussed under section 3.2 of this paper.

Further, the calculation of the flat rate compensation amount might be controversial in regards to whether subsidies should be included in the amount of income and which macro-economic data should be used for different kinds of farming activities.<sup>116</sup> As a result, since the estimation is general, despite the Article that stipulates there should not be a refund above the input VAT, the flat rate compensation might not be exactly equal to the actual input that would have been deducted. If there is underestimation of the amount, it will still result on VAT ccumulation in spite of its aim to avoid cumulation. Furthermore, even if over evaluation might avoid VAT cumulation, it will be unlawful hidden state aid on one hand and against Article 299 of the Directive on the other hand. Therefore, in most cases, total avoidance of VAT cummulation just like the normal VAT arrangement is farfetched and only partial mitigation of VAT would be achieved.

The other drawback of the scheme is the complexity of the rules related to intra Community acquisition and supply of goods made by flat-rate farmers. Article 3(1)(b)of the VAT Directive stipulates, provided that a minimum threshold under Article 3(2)(A) is not exceeded, the intra-Community acquisition of goods by a “flat-rate scheme farmer” for the purpose of his agricultural, forestry or fisheries undertaking are not subject to VAT. The contrary reading of this Article stipulates that intra Community acquisition of goods by “flat-rate scheme farmer” should be

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<sup>112</sup> Alan A.Tait, p 142

<sup>113</sup>Csaba Csáki and Zvi Lerman(Ed), *Structural Change in the Farming Sectors in Central and Eastern Europe: Lessons for the EU Accession : Second World Bank/FAO Workshop, June 27-29, 1999* (Volumes 23-465, World Bank, 2000) 173

<sup>114</sup>HM Revenue and Custom Authority, accessed 15 May 2014; Council Directive 2010/45/EU of 13 July 2010 amending Directive 2006/112/EC on the common system of value added tax as regards the rules on invoicing, Art 219(A)(1),

<sup>115</sup> Council Directive 2006/112/EC, Art 303(1),167,168,169,173-177; Council Directive 86/560/ EEC 1986, Council Directive 2008/9/EC of 12 February 2008

<sup>116</sup>P. Zeiger A. Nurk J. Lehtsaar R. Värnik ‘Possibilities and contradictions in the calculation of the flat rate of the Value Added Tax Special Scheme for farmers in the European Union based on the Estonian example’ (2008) vol 6.1, Agronomy Research, pp 91-99



subject to the normal scheme of VAT if it is done for the purpose other than of agricultural, forestry or fisheries undertaking.<sup>117</sup> This does not mean flat-rate scheme farmer are denied from making intra Community acquisition of goods, but it means in the event they do the transaction is not subject to VAT.<sup>118</sup>

In line with this exception, the place of supply of the intra-Community acquisitions of goods by flat-rate farmer is deemed to be the place where the goods are located at the time when dispatch or transport of the goods to the customer ends.<sup>119</sup> This is for goods dispatched or transported by or on behalf of the supplier from a Member State other than that in which dispatch or transport of the goods ends. Accordingly, Article 305 of the Directive obliges Member States to take all measures necessary to ensure that the supply of agricultural products between Member States is always taxed in the same way, whether the supply is done by a flat-rate farmer or another taxable person. Further Article 213 of the VAT Directive that deals with identification states that in the case of intra-Community acquisitions of new means of transport flat-rate scheme farmers that are above the threshold of EUR 10,000 need to register and get identification numbers.<sup>120</sup>

These rules make the CFRSF more uncertain and complex in light of intra Community acquisitions and supply goods even more than the general scheme for SMEs enshrined in the Directive. The complexity will hinder the effectiveness of the system by defeating the simplicity aim of the scheme. Furthermore, even though as discussed above the rules are not straightforward on paper, the practical application of the rules might even be more difficult. Therefore, before voting to extend this scheme for all SMEs one needs to decide first if partial avoidance of VAT cumulation should override simplicity, fair competition and effectiveness.

#### **4.1.2. The Equalization tax scheme**

Similar to the above schemes under the VAT equalization scheme small business are also exempted from registering under the normal VAT arrangement. The equalization tax is implemented in two ways. The first is done in the form of imposing a higher tax rate on small business, and the second is done in the form of making a small business pay a certain percentage calculated of the annual turnover. These equalization taxes are beneficial to mitigate the competitive advantage of SMEs with a registered business supplying for consumers and still offer simplification.

##### ***4.1.2.1 Equalization tax in form of subjecting sales to exempted SMEs to an higher rate of VAT***

This equalization tax is done by subjecting small traders below certain annual turnover or payable VAT to pay higher rate VAT than the regular VAT rate.<sup>121</sup> The previous practice of some countries such as Belgium shows that under this method a small business could opt to be taxed under the equalization scheme by obtaining a specific identification number for it.<sup>122</sup> Afterwards, the supplier of the SME will have to collect a certain amount of tax from the small business and pay

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<sup>117</sup> Ben Terra & Julie Kajus, p 411

<sup>118</sup> Ben Terra & Julie Kajus, p 411

<sup>119</sup> Council Directive 2006/112/EC, Articles 3(1), 32, 33

<sup>120</sup> Ben Terra & Julie Kajus, p 1067

<sup>121</sup> Ben Terra & Julie Kajus, 275

<sup>122</sup> Alan A.Tait, p 119

this amount to the tax authority.<sup>123</sup> Therefore since they have already been charged the extra VAT, the small traders need to account for their future sale and they do not have to pay output VAT to the authorities. In other words, this method transfers the obligation of accounting output VAT from the small business to its suppliers. Under this scheme, some small businesses might be able to reclaim the VAT they paid for some investment goods.<sup>124</sup> This equalization tax will help to mitigating distortion of competition caused by reduced prices of SMEs due VAT free supplies. However, it also has the following main drawbacks:<sup>125</sup>

- It can only be used for some retails with uniform and well predictable markup
- The requirement to keep separate books and accounts for each costumers depending whether it is a small enterprise under this scheme, under the general scheme or final consumers creates excessive burden on suppliers who have different types of customers
- It transfers burden of administration from tax authorities to suppliers of the SMEs

Therefore even if this approach of treatment of SMEs can be appreciated from the point of mitigating elimination of the administrative burden of both tax authority and small business, it is widely unfair for suppliers. Consequently, suppliers to small business do not only need to worry about their own output VAT, but also about the equalization tax collected from a small business in the form of higher VAT rate. Furthermore, it also does not eliminate the full burden of VAT compliance as the small businesses under this scheme still need keep invoices of their purchases to proof to the tax authority they have already paid the equalization tax to their suppliers.

#### *4.1.2.2 The Equalization tax in the form of a fixed lower rate paid by the SMEs*

SMEs below the VAT registration threshold will have to register under this equalization turnover tax. Under the scheme SMEs do not charge VAT nor deduct the VAT, they paid on their inputs. Instead, they have to pay a percentage of their turnover, which is estimated to be equal to the VAT rate on the added value of their sales. This fixed percentage is estimated to be close to the percentage of the VAT they would have to pay if they were able to deduct VAT. For example if there is a VAT rate of 15% and they made a gross profit of 20% then the equalization tax will be 3%. This equalization tax scheme is applicable in most developing countries such as Ethiopia, South Africa and Bangladeshi known as turnover tax (TOT).

On the bright side, since SMEs are required to neither maintain books and records nor account for VAT it will significantly reduce VAT compliance and administrative cost. However, small traders under the scheme might sometimes be in a problem because they might not understand they need to add the 2% or 3% on their price so that they will pay it in addition to income tax at the end of the accounting period. As a result, in countries that implement this equalization tax since SMEs registered under this scheme will not differentiate this turnover tax from profit tax, there will be a lot of disagreement with the tax authority claiming they did not make that much profit. Thus, countries, which implement this equalization tax, need to give a detailed explanation for the SMEs as early as possible.

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<sup>123</sup> Alan A.Tait, p 119

<sup>124</sup> Alan A.Tait, p 119

<sup>125</sup> Alan A.Tait, p 120

When we look at a possible application in the EU, it might be argued that this separate turnover tax breaches Article 401 of the current VAT Directive that dictate no other tax with characterization of turnover tax could be implemented by Member States except VAT. Even if this kind of equalization tax seems to be a separate retail turnover tax, it is could also be argued that, it should be considered another way of taxing the estimated value added instead of labeling it as another turnover tax

#### 4.1.3. Graduated tax relief (curving scale)

Graduated tax relief used to exist before the harmonization of VAT in different Member States based on various requirements. For example in Germany, Denmark, the United Kingdom, Ireland and Luxembourg the graduated tax relief was fixed by a turnover ceiling of a small business while in France and Netherlands it was fixed by payable VAT.<sup>126</sup> These Member States are permitted to keep the graduate tax relief scheme for SMEs by Article 284 of the current Directive.<sup>127</sup> This shows the current different treatment of SMEs in definition and approaches of treatment of SMEs is the continuation of these old practices despite harmonization efforts.

This graduated reduction of the VAT payable related to either net tax payable or to turnover is mostly applied to SMEs that are just above the threshold in order to mitigate the effect of VAT on them.<sup>128</sup> Such graduated tax relief systems are advantageous especially in that they reduce the temptation of business to restrict their business from expansion for the fear of exceeding the turnover ceiling of the exemption scheme.<sup>129</sup> Therefore, applying the graduate relief independently or in combination with the exemption scheme will enhance the transformation of SMEs to bigger ones. Furthermore, the fact that Article 290 of the VAT Directive permits graduated tax relief even in the event SMEs opt for taxation encourages opting for taxation.

However, this approach might not always relieve SMEs from compliance costs such as invoicing and bookkeeping. For example in the Nethralnd, exemption is based on payable VAT instead of an annual turnover threshold.<sup>130</sup> Therefore, SMEs might need to invoice VAT and deduct input VAT in the normal way just like under the normal arrangements because eligibility for exemption and the curving scale is assessed by the calculation of the net payable VAT after input and output are considered.<sup>131</sup> However, in some instances if the VAT to be paid after deduction of input VAT is less than a certain amount the sole trader may request to be relieved from bookkeeping obligations.<sup>132</sup> Therefore, even if this scheme is advantageous for expansion of SMEs it may not always release SMEs from all of their duties related to VAT as the exemption and the equalization scheme. In fact, Article 291 of the Directive stipulates that SMEs that have graduated tax relief shall be considered like taxable persons under the normal arrangement.

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<sup>126</sup> *Description, Analysis and Suggestions for the Harmonization of National Schemes for Small Undertakings*, p 25

<sup>127</sup> Also see Council Directive 67/228/EEC of 11 April 1967, Art 14

<sup>128</sup> *Value-Added Taxes in Central and Eastern European Countries*, p 112

<sup>129</sup> *Description, Analysis and Suggestions for the Harmonization of National Schemes for Small Undertakings*, p 17

<sup>130</sup> *Description, Analysis and Suggestions for the Harmonization of National Schemes for Small Undertakings*, p 25

<sup>131</sup> *Description, Analysis and Suggestions for the Harmonization of National Schemes for Small Undertakings*, p 9

<sup>132</sup> Expatax, 'VAT legislation' <<http://www.expatax.nl/vatrules.php>> accessed 20 May 2014

## 4.2. Simplification methods that can be used without exemption of SMEs

Under Article 281 of the current VAT Directive, as long as it does not lead to a reduction of tax, Member States are permitted to implement different simplification methods for mitigating the burden of VAT on SMEs. In order to achieve the need for special treatment, the simplifications legislation, regulations and forms can be formulated “guided by the four principles:

- (i) *Do not request more information than will be processed and used for the tax administration’s purposes;*
- (ii) *Provide simple and clear information on what, how, where, and by when actions should be completed, and clearly delineate record keeping requirements;*
- (iii) *Standardize procedures nationwide in order to avoid different treatment across different offices; and*
- (iv) *Operate with transparency and public accountability”<sup>133</sup>*

Furthermore, it can be understood from CJEU case law that Member States may adopt simplification scheme only to the extent necessary to achieve its objective.<sup>134</sup> In doing so, they should not exceed the power granted to them under Article 281 of the VAT Directive.<sup>135</sup> It has also been emphasized by the Court the simplification methods under Article 281 could not include total exemption from VAT.<sup>136</sup> Further, simplification method instead of general exemptions from EU legislation are also important because some registered interest representative contend that, since just like big companies micro enterprises are also part of EU, “Any general exemption of micro enterprises is to be rejected, not just from a legal and SME policy perspective but also and in particular for micro-economic reasons.”<sup>137</sup> Therefore, under this section, simplification methods that can be used for collecting VAT without exempting them from VAT will be discussed.

### 4.2.1. Cash flow method (cash accounting)

Accounting has been identified to be one of the crucial areas that impose great administrative burden to all business.<sup>138</sup> However, the administrative burden is more disproportional for small undertakings than for a larger businesses due to the lack of sufficient resources of the former. As a result, in order to address the problem micro-enterprises are in some cases exempted from the normal accounting rules and regulations.<sup>139</sup> This special treatment of SMEs regarding accounting rules is most relevant in the area of VAT because it might even be more burdensome more than a declaration of loss and profit for the purpose of income tax.

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<sup>133</sup> Taxation of Small and Medium Enterprises, p.43

<sup>134</sup> Judgment in *Jyske Finans*, C-280/04 EU:C:2005:753 para 35 as cited on Judgment in *Commission v Austria*, C-128/05, EU:C:2006:612, para 22

<sup>135</sup> Judgment in *Commission v Austria*, C-128/05, EU:C:2006:612, para 20

<sup>136</sup> Judgment in *Commission v Austria*, C-128/05, EU:C:2006:612, para 25

<sup>137</sup> UEAPME, ‘Position Paper on the Report from the Commission to the Council and the European Parliament “Minimizing regulatory burden for SMEs – Adapting EU regulation to the needs of microenterprises” (COM (2011) 803 final of 23.11.2011)’ (Brussels, 27 January 2012) < <http://www.ueapme.com/spip.php?rubrique54>> accessed 15 may 2014, p8

<sup>138</sup> DIRECTIVE 2012/6/EU of the European Parliament and of the Council of 14 March 2012 amending Council Directive 78/660/EEC on the annual accounts of certain types of companies as regards micro-entities, Second Recital

<sup>139</sup> *ibid*

The EU VAT accounting method is the credit method.<sup>140</sup> In the credit method, taxable persons are “permitted to reduce the amount of VAT they must remit to the government by a credit equal to the amount of VAT paid to other registered businesses in [the] purchasing business”.<sup>141</sup> However, since this credit method is complicated and requires detailed practical accounting rules, the cash flow method is permitted for SMEs instead. The Commission proposal that allows micro enterprises to be exempted from the accounting has been adopted.<sup>142</sup> Although the Commission, initially proposed it will save ECU 6.3 billion, the fact that the legislator during the time of adoption limited it to only certain micro enterprise compared with the Commission’s proposal reduced this potential saving to 3.4 billion Euro.<sup>143</sup> However, this, still significant amount, must not go without appreciation.

SMEs under the cash flow accounting method do not have to account for output VAT unless they received the payment and only deduct input VAT only when they have paid the VAT on their business purchases.<sup>144</sup> Thus unlike the credit method, under cash accounting, the game changes from to be receivable and to be payable to received and paid. This makes it easier for SMEs to control their accounts based on their cash flow than future invoices. The cash accounting method thus changes the normal chargeable event rules under the Directive.<sup>145</sup> Similarly, early proposals show that the chargeable event should occur when there is payment for the goods or services and the right to deduct arises when the taxable person paid for the purchase of goods or services.<sup>146</sup>

The different chargeable event rule applicable between the cash flow and credit method might cause problems to a taxable person who wishes to trade with each other while applying different accounting methods. For example in the credit method, business has a chance to deduct input VAT even if they have not actual made out expenditure yet. However, since this is not the case for the cash flow methods small business that are applying cash flow accounting might loss registered business customers who apply the credit method. Further, the cash base accounting have disadvantageous especially to purchase of expensive capital goods with extended payment as well as to zero rated exporters entitled for a refund.<sup>147</sup>

Despite the above disadvantages, registering for VAT with cash flow methods could still be preferred than the general exemption because it preserves the right to deduct input VAT that will intern prevent VAT cascading in the long run. It is also safer to ensure no reduction of tax happens. However, it will be more beneficial if it could be combined with the other simplification methods discussed underneath.

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<sup>140</sup> *Effects of adopting a value-added tax*, P 24

<sup>141</sup> Itai Grinberg, ‘Implementing a Progressive Consumption Tax: Advantage of adopting credit method system’ ( 2006) Vol. 59, No. 4, National Tax Journal, p 932

<sup>142</sup> European Commission, *Action Programme for Reducing Administrative Burdens in the EU final report* (Commission staff working document, SWD(2012) 423 final, Strasbourg, 12.12.2012 ) p15( here in after *Reducing Administrative Burdens in the EU*)

<sup>143</sup> *ibid*

<sup>144</sup> *Key Issues and Policy Considerations*, P 123

<sup>145</sup> *Description, Analysis and Suggestions for the Harmonization of National Schemes for Small Undertakings*, P 20

<sup>146</sup> European Commission Proposal for a Council Directive amending Directive 77/388/EEC on the harmonization of the laws of the Member States relating to turnover taxes in respect of the common value added tax scheme applicable to small and medium-sized businesses, Art 6(B)(C)

<sup>147</sup> *Value-Added Taxes in Central and Eastern European Countries* p 115

#### 4.2.2. Relying less on the importance of invoices

Since an invoice is considered as proof of compliance, it has extremely detailed rules in its both content and administration. For example, the entire chapter 3 under title XI of the current Directive is dedicated for invoices and Article 226 alone prescribes about fifteen points an invoice should contain. Despite this, it is possible to forge invoices necessitating proper audit to enforce VAT compliance.<sup>148</sup> Therefore, in order to avoid such burden, among other ways, taxing at flat rate is one way to collect VAT with less invoice requirements.<sup>149</sup> Presumptive and the forfeit are also methods used in the absence of invoices. Relying less on invoices is advantageous as entrepreneurs could simply start a business without worrying how to learn the detailed VAT invoicing rules.<sup>150</sup> The main advantage of this approach is that it could be applied to tax the hard to tax such as SMEs in which detailed self-assessment rule is unreasonable whereas the disadvantage is its difficulty to eliminate and replace by other methods.<sup>151</sup>

In presumptive method, the calculation of turnover could be done by imputing or estimating the payable VAT with the help of indications such as type of business, location and other relevant factors for income generation.<sup>152</sup> The presumption method could be done in the form of different flat rate or special schemes. The flat rate could be individual or collective, which is usually, calculated based on the turnover exclusive of VAT.<sup>153</sup> For example in UK, it is done by calculation of the VAT inclusive turnover whereas in Belgium it is implemented by setting the turnover with special rules that will also allow deduction of input VAT under the normal arrangement.<sup>154</sup>

This method has the drawbacks of “significant amount of uncertainty surrounding the interpretation of many tax provisions, leaving firms vulnerable to arbitrary decisions by tax inspectors and setting the stage for bribery and corruption.”<sup>155</sup> This problem is more severe for small business as they may not usually afford legal consultation to protect themselves from corruption and in the event they could, they may prefer to collaborate with the corrupted officials if it results in the estimation of less payment of VAT. Some consider that since most of the presumption schemes in EU just add administrative cost without contributing to the revenue of the state that much, it is better just to exempt SMEs without any other arrangements attached.<sup>156</sup>

The Commission proposal stipulates Member States may fix flat rate percentage for some taxable persons with sufficiently homogenous purchases as long as it does not result in a reduction of tax.<sup>157</sup> However, the ambiguity of what is sufficiently homogenous and the difficulty to evaluate accurately if there is in fact a tax reduction makes this simplification method problematic. This could open dialogues between Member States and the Commission that are difficult to certainly

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<sup>148</sup> *Value-Added Taxes in Central and Eastern European Countries*, p 134

<sup>149</sup> *Effects of adopting a value-added tax*, P 14

<sup>150</sup> Sally Wallace ‘imputed and presumptive tax international practices lesson for Russia, International studies program’ (2002) working paper 02-03, Georgia state university, P 54 (here in after Sally Wallace)

<sup>151</sup> Sally Wallace , P 52

<sup>152</sup> Sally Wallace , Pp 51,3

<sup>153</sup> *Description, Analysis and Suggestions for the Harmonization of National Schemes for Small Undertakings*, P 35

<sup>154</sup> *Key Issues and Policy Considerations*, P 123

<sup>155</sup> OECD, *Economic Surveys Poland* (Volume 2008/10, June 2008), p32

<sup>156</sup> *Value-Added Taxes in Central and Eastern European Countries*, p 112-113

<sup>157</sup> Proposal for a Council Directive amending Directive 77/388/EEC on the harmonization of the laws of the Member States relating to turnover taxes in respect of the common value added tax scheme applicable to small and medium-sized businesses, Art 6(G)



proof on one hand, and the Member States and the taxable person on the other hand. This is because the homogeneity of business cannot be the identical without variations starting from the difference business decision making run by two independent taxable persons. Hence, this will finally result in the forfeit scheme in which one is willing to let go. Even in this instant since making sure there is no reduction of tax is mandatory and not optional requirement it might be difficult to forfeit in the side of Member States without the breach of Article 281 of the Directive. Thus, Member State might choose to resort to fixing higher rate to be in the safe side. This will contribute to partial hidden unrecovered input VAT necessitating its incorporation into the price. Of course, this again will put SMEs in unfair position, in the era of competitiveness.

Furthermore, in the absence of invoices that could be relied on for calculation of the tax due, Member States might need to implement simplification schemes such as the “forfeit scheme”. This method of calculation is applicable in different countries such as Belgium, Argentina and Nigeria.<sup>158</sup> To apply this system, tax authority and the small trader have to come up with certain arrangements to decide the amount of seal based on some factors such as trading results for a previous year with the adjustments on the price that are relevant for all or only the particular small undertaking.<sup>159</sup> Therefore, the VAT is assessed based on mutual understanding of the tax authority and the small business instead of actual calculation of input and output VAT.<sup>160</sup> In some cases, instead of such arrangements, payable VAT could be calculated by the tax authority based on prior business survey or could be done by the SMEs by applying specific turnover in the threshold as it might be easier to estimate the turnover than the purchases they made.<sup>161</sup>

The effectiveness of these systems depends on the comparison of traders. In addition, the tax authority has to make in-depth review of the market situation in order to come up with the best profit margin analyzed from different factors such as inflation, consumer's behavior and any other issues that might bring change on the amount of the annual turnover. Thus, this method although relieve small taxpayers from the significant cost related to invoices, the tax authority have to invest their energy to estimate the correct amount. Thus, as discussed early even if one reason for the special treatment of SMEs is to save the tax Authority from an administrative burden disproportional to that VAT collected, this method will undermine this aim by requiring strict regulation on the side of the government.<sup>162</sup> For similar reasons, Allen A.Tait suggests, to reduce the workload of the tax authority, the forfeit method should be implemented in combination with income tax assessment rather than having a separate assessment for VAT.<sup>163</sup> However if implemented with due diligences it might be significant simplification tools envisaged by Article 281 of the Directive.

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<sup>158</sup> Alan A.Tait, p 120

<sup>159</sup> Alan A.Tait, p 120, Tera 275

<sup>160</sup> The World Bank Group, *Designing a Tax System for Micro and Small Businesses: Guide for Practitioners*, (in collaboration with DFID, December 2007), pp51-52

<sup>161</sup> *Value-Added Taxes in Central and Eastern European Countries*, p 112

<sup>162</sup> Alan A.Tait, p 121

<sup>163</sup> Alan A.Tait p 121

### 4.2.3. Softening Reporting obligations

It is enshrined under Article 250 of the current VAT Directive that taxable persons are obliged to submit a VAT return. This obligation might perhaps be considered the most difficult to maintain by SMEs just like other obligations such as maintain proper books and accounts. In line with this Article 172(1)(d) allows Member States to exempt from compliance obligation such as the VAT return enshrined in the Directive. By their nature, small businesses are usually operated by the owner without additional employees for discharging these obligations. Hence, this obligation might often mandate to close their business in order to go to the tax office to declare VAT returns. Hence, if SMEs are not exempted from VAT, simplification of the methods and frequency of filling VAT return has to be incorporated in the system.

#### 4.2.3.1 Less frequent Reporting obligations

Since the obligation to make VAT, return every month is difficult for small businesses; this rule is more flexible on SMEs. Therefore, some Member State could reduce the frequency of VAT declaration as a simplification method. For example in Netherland even if normally VAT returns are made quarterly and even monthly for some business, small business are permitted to report only once a year if the payable VAT is not higher than NLG 2 000 (€908) a year.<sup>164</sup> Further more, they will benefit as they will receive periodical invitations reminding them to file the VAT return.<sup>165</sup> Similarly, in Denmark, small business can fill return quarterly or only twice a year<sup>166</sup> whereas firms with a turnover below one million SEK are permitted to declare a VAT payments as income tax declaration in Sweden.<sup>167</sup>

Since Sweden secured this even at the time of the accession, Article 253 of the EU VAT Directive explicitly states that Sweden is permitted to apply a simplified procedure for SMEs in which taxable persons carrying out only transactions taxable at national level may submit VAT returns three months after the end of the annual direct tax period. OECD statistics shows that Sweden has the lowest administrative cost compared with other EU countries by stating that the administrative cost in EU ranges from US\$ 68 in Sweden to US\$ 175 in Belgium.<sup>168</sup> The reason for this could be closely aligning VAT with income tax and simplicity in the VAT design<sup>169</sup> such as granting annual return. Therefore, extension of this trend to SMEs in other countries that are included in the general VAT arrangement by opting for taxation or because of the absence of an exemption will mitigate the excessive reporting burdens SMEs face.

For reasons stated above, the Commission has proposed for annual accounting of SMEs that is worth saving more than ECU 10 billion administrative costs.<sup>170</sup> The Commission also proposes that micro enterprises with an annual turnover less than EUR 2,000,000 can submit quarterly VAT

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<sup>164</sup> European Commission directorate-general, *VAT and other turnover taxes application in the member and accession states Netherlands*( brussels, taxud/c/3/id d(2003), 27 october 2003) p 7

<sup>165</sup> Government of Netherlands 'VAT and excise duty' <<http://www.government.nl/issues/taxation/vat-and-excise-duty>> accessed 17 May 2014

<sup>166</sup> *Key Issues and Policy Considerations*, P 124

<sup>167</sup> Takis Venetoklis and Timo Rauhanen 'Graduated tax relief system of VAT in Finland' (2008) Government Institute for Economic Research VATT, p 4

<sup>168</sup> *Value-Added Taxes in Central and Eastern European Countries*, p 142

<sup>169</sup> *Value-Added Taxes in Central and Eastern European Countries*, p 142

<sup>170</sup> *Reducing Administrative Burdens in the EU*, p 15



returns if it does not risk the collection of VAT.<sup>171</sup> However, annual submission might perhaps be better instead of quarterly.

The risk with prolonged time of submission of the VAT return is that it might cause revenue gap for the Member State as well as it is more prone to risk of VAT fraud compared with the normal monthly VAT return. Furthermore, even if a small business is less likely to engage in carousel fraud, annual VAT return instead of monthly facilitates the disappearance of business before making eligible VAT return.

#### *4.2.3.2 Standard VAT return*

Currently, there is different trend of filling VAT return both in term of frequency and content of the return with a range of boxes from five to twenty-six.<sup>172</sup> This creates uncertainty on how and when it should be done. Therefore, the Commission has proposed to bring standard VAT return, which can be applied, in all Member States uniformly.<sup>173</sup> In line with the priority files in the Commission Work Program 2013 for SMEs, Making business easier through a standard VAT declaration<sup>174</sup> the context of this proposal notes that,

*“Building on the "Think Small First" principle from the Small Business Act by cutting "red tape" for SMEs is a key Commission aim. The recent Communication on Smart regulation - Responding to the needs of small and medium-sized enterprises has highlighted, from an online survey of SMEs, the VAT Directive as an area of EU legislation most burdensome. ... this proposal aims to reduce burdens on all business, and particularly SMEs, and is highlighted in the Communication on Smart regulation”<sup>175</sup>*

This is especially true since as discussed in the previous sections of this paper SMEs are in a difficult position especially regarding intra-Community transactions, which require registration in other Member States. Further small business has also to submit foreign VAT returns for intra Community transactions, which results in discouraging small business from selling goods to customers located in other Member States.<sup>176</sup> This problem is further intensified as the self-employed small business owners usually lack professional knowledge in terms of both tax issues and language. However, the adoption of the standard VAT return might partially solve this problem because it will implement harmonized rules and regulations the small business is used to in its own member state. Therefore, it is also true for small business even more than the larger one

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<sup>171</sup> European Commission Brussels, proposal for a council Directive amending Directive 2006/112/EC on the common system of value added tax as regards a standard VAT return, 23.10.2013 com(2013) 721 final 2013/0343 (CNS) p5. see also Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (OJ L 124, 20.05.2003, p. 36) as cited in the Commission proposal for the standard VAT return.

<sup>172</sup> David D. Stewart ‘European Commission Proposes Standard VAT Return’ (Tax Analysts Doc 2013-24566, OCTOBER 24, 2013) p 2

<sup>173</sup> Proposal COM(2013) 721 of 23 October 2013 for a Council Directive amending Directive 2006/112/EC on the common system of value added tax as regards a standard VAT return

<sup>174</sup> European Commission staff working document Monitoring and Consultation on Smart Regulation for SME, Brussels, 7.3.2013 SWD(2013) 60 final, Page 14

<sup>175</sup> European Commission proposal for a council Directive amending Directive 2006/112/EC on the common system of value added tax as regards a standard VAT return, Brussels, 23.10.2013 COM(2013) 721 final 2013/0343 (CNS), p 2, (here in after Commission proposal as regards a standard VAT return)

<sup>176</sup> Iris Hohmann, Anna Beil, Dr. Matthias Kullas, ‘EU Directive standard VAT return for businesses’ (cep Policy Brief No. 2014-07, 2014) p 3

that “An EU-wide standard form and the harmonization of the tax periods, deadlines for submission of VAT returns and deadlines for payment of tax, make it easier for businesses to submit foreign VAT returns and thus strengthen the single market.”<sup>177</sup>

As discussed in the first chapter of this paper the aim of special treatment of SMEs is to benefit both the business and the tax authority. The standard VAT return complements this aim as noted by the Algirdas Šemeta, the proposed standard VAT return creates a win-win situation in which businesses will enjoy simpler procedures, reduced costs and less red tape while at the same time it helps the tax authority by facilitating VAT compliance to increase the revenues they collect.<sup>178</sup> Furthermore, the application of the standard VAT rate is also beneficial in the uniform application of the definition of micro, small and medium-sized enterprise because it is in conformity with the proposal for the common definition of these enterprises in EU.<sup>179</sup>

Considering the need of SMEs as discussed above as well as the need to ease burden on all business and remove the obstacles to hinder the internal market makes the amendment of the VAT Directive in this aspect is proportional to the objectives to be achieved.<sup>180</sup> Therefore, if the proposal receives acceptance by the EU Council and Parliament, it could be one significant tool for addressing the need of SMEs that are not exempted from EU VAT. The fact that it will be applicable to all business irrespective of the size is also beneficial in light of fair competition and neutrality of the tax system while at the same time it maintains the right to deduct of SMEs.

#### 4.2.3.3 Use of electronic means (E- return)

Article 252(2) of the Directive gives the option to Member States to allow submission of the return by electronic means. The writer believes this should be facilitated and implemented specially for SMEs. “It is estimated that if all businesses adopted e-invoicing savings would amount to EUR 18 billion in the medium term, which represents a 26 % reduction in VAT administrative burdens.”<sup>181</sup> Giving due consideration for this, the proposal for standard return also encourages the use of electronic filing.<sup>182</sup>

This is especially more applicable in developed more than developing economies due to better availability of internet. The simplicity of e-return can be especially advantageous to small enterprises, as it does not require detailed computer knowledge because it is usually just like filling forms online. The fact that it could be done from anywhere as long as there is access to the internet, makes it vital for SMEs as they don't have to close their business and go to the tax office whenever they need to declare VAT. This of course saves time, energy and money for them. It is also vital for efficiency of the tax system, as it will contribute to the implementation of VAT according its basic principles with less cost. A member state, which does not wish to extend E-filing to all business, might just restrict it to small business just as a form of special treatment in order to avoid the disproportional compliance burden of small business compared with the bigger

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<sup>177</sup> *ibid*

<sup>178</sup> European Commission, *Standard VAT Return: Easing life for businesses and improving tax compliance*, (PRESS RELEASE IP/13/988, Bruxelles, 23 October 2013)

<sup>179</sup> Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium- sized enterprises (OJ L 124, 20.05.2003, p. 36) as cited on Commission proposal regards a standard VAT return, p 2

<sup>180</sup> *IBID*

<sup>181</sup> *Reducing Administrative Burdens in the EU*, p 35

<sup>182</sup> Commission proposal as regards a standard VAT return, p 2

once. For instance, Chile has recognized the importance of e- services to SMEs by designing a comprehensive program for it.<sup>183</sup> This program is designed to depend heavily on advanced information technology instead of adoption of special schemes for SMEs by extending an online tax and business life cycle resulting in electronic tax administration communication, registration, filing and payment.<sup>184</sup>

Since E- return will not result in tax reduction as described under Article 281 of the Directive, it could be one simplification method implemented in all Member States in EU. Compared to the exemption scheme this approach might incur the tax administrator some costs such as practical training to the taxpayers and designing software. However if implemented it will avoid the problems related to denial of deduction of input VAT. Further, it will ensure that similar goods are taxed similarly for the purpose of fair competitions and economic neutrality.

#### **4.2.4. Simplifying Rates: A reduced rate for labor intensive small business and standard rates**

Another method to address the needs of SMEs could be through-making rates friendly to SMEs. This could be done by form of applying reduced rate for labor-intensive business and subjecting the supply of SMEs to single rate irrespective of the category of good and services they supply.

Since reduced rates has been applied in the EU as an exception to the rules, the current VAT Directive under Article 98 permits Member State to have one or two reduced rate for the supplies of goods or service under annex three of the Directive. This reduced rate used to be applicable on limited activities. However, currently it has included most of the business that could be performed by SMEs such as minor repairing of bicycles, shoes and leather goods, clothing household linen (including mending and alteration); domestic care services such as home help and care of young, elderly, sick or disabled and hairdressing.

Normally as consumption decrease with an increase of income, reduced taxes are argued to be beneficial good for lessening the effect of the regressive tax.<sup>185</sup> It is known that SMEs supply most of their products to consumers with less income. Therefore, the applicability of reduced rate on SMEs supplies is beneficial in this aspect. The hidden tax on the price might be better off with reduced rate than taxing at standard rates. Furthermore, the application of reduced rate will also help SMEs competitiveness as it will reduce the price helping them to offset the excessive compliance cost they bear compared with large business.

On the other hand, some argue against the application of reduced rate. The reasons for this are, the speculation of advancement of income equalization schemes will disappear the consumption pattern difference between the rich and the poor; the problem of low income group are the concern of the social security system and not the tax system and the fact that dual rate structure distorts consumer and production choices.<sup>186</sup> However, it is submitted here that, since the VAT tax system

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<sup>183</sup> Taxation of Small and Medium Enterprises, p.51

<sup>184</sup> Taxation of Small and Medium Enterprises, p.51

<sup>185</sup> Sijbren Cnossen 'what rate structure for a value-added tax?' (June, 1982), Vol. 35, No. 2, National Tax Journal, pp 205-209 (here in after Sijbren Cnossen)

<sup>186</sup> Sijbren Cnossen

is sensitive to the low-income characteristics of both SMEs and their customers, it should be designed in a manner that address their needs.

Having a single rate instead of multiple rates could also ease the burden and compliance costs involved in VAT. For instance, one study reports that that compliance costs would be reduced on average by 30 percent in Sweden if a single rate system could replace multiple rates.<sup>187</sup> This seems to support the claims of countries such as UK, Netherlands and Spain, which contend that SMEs are capable of maintaining accurate records of sales and purchases, but their problem is the application of different rates to different services and goods they supply.<sup>188</sup> However, this may not always be true because most SMEs do not have different transactions they supply with different rates as they mostly specialize only in one type of business subject to similar rates. Still in the event, they supply good and services with different rates subjecting all of their transactions to single standard or reduced rate might help their difficulties.

## 5. Summary and conclusion

VAT requires higher compliance costs compared with other taxes. However, the fact that the compliance burden of VAT is highly regressive as size decreases necessitates the special treatment SMEs. Although SMEs are vital for Europe economy in terms of both innovation and entrepreneurship, SMEs usual have limited resource that cannot survive to discharge the regressive burden. Further, the disproportionality of the tax collected compared with the cost of collection incurred by the tax authority justifies the special consideration of SMEs. Therefore, SMEs need special treatment to mitigate the heavy administrative burden on both SMEs and the tax authority. The writer agrees due to their nature SMEs might require state aid and separate benefits. However, state aid and other SMEs support schemes should be implemented through systems other than VAT in order to observe the economic neutrality of VAT and its main essence, which are essential for the effectiveness of the tax system. In other words, the special treatment of SMEs in VAT should only be done for combating the excessive administrative burden and should not be used for extending hidden state aid or other special protection to these enterprises.

In line with this, the current VAT Directive also extends special treatment for SMEs mainly focusing on an exemption from VAT. When we see the current exemption scheme as it is, it is optional for states to adopt it if they consider there is difficulty in implementing the normal arrangement of VAT on SMEs. Although payable VAT is also applicable, this special scheme uses a turnover to define which undertakings are eligible for this scheme. The provisions of the current Directive dealing with the treatment of small undertakings are filled with points that allow the current Member States to continue their practice before harmonization. Further, the turnover limit for defining SMEs is also different based on time of accession and other reasons. Therefore, despite the harmonization of VAT in EU, the treatment of SMEs varies in the different member states. Although the writer appreciates the flexibility of the provisions in letting Member States design their own special treatment according to the situation of their small undertaking, this flexibility undermines the harmonization of VAT. It also opens the door for tax competition among member states. This might not be a problem from the fundamental freedoms point of view as long

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<sup>187</sup> Swedish National Tax Board (2006), “Compliance Costs of Value-Added Tax in Sweden”, Report 3B, Stockholm as cited on *Key Issues and Policy Considerations*, P 122

<sup>188</sup> *Value-Added Taxes in Central and Eastern European Countries*, p 113

as the Member States treat both domestic and other EU SMEs the same way. However, it surely is obstacle for achieving harmonized single market within the EU. Therefore, the need for abolishing fiscal boundary and harmonization of VAT requires the different treatment of SMEs among Member States to be uniform.

When it comes to the technical aspect of the exemption scheme provided by the Directive, it denies the deduction of input VAT for SMEs. Normally, it is known that VAT is a tax on consumption or a tax on expenditure for consumption. However, the denial of right to deduct makes VAT a tax on expenditure to supply by totally redefining the essence of VAT. This further creates cascading of VAT and the need to transfer the burden as part of the price similar to the income tax. It is also an obstacle for SMEs business relationship with registered taxable persons with the right to deduct. To mitigate these problems and also since it might be unfair to label all SMEs as incompetent to discharge the VAT compliance burden, there is an optional registration for business that are better off within the tax. However, even this further distorts neutrality and fair competition among SMEs.

Apart from the exemption scheme, Article 281 of the Directive makes it possible for Member States to adopt other simplification schemes that address the needs of SMEs. However, no matter how vulnerable and important SMEs are "...SMEs cannot expect to be above the law."<sup>189</sup> Therefore the special schemes and the simplification methods discussed in this paper as well as any other simplification methods must be implemented as long as it is in conformity with the law. Member States in particular have to be cautious while extending the special treatments in that:

1. It must address the need for special treatment of SMEs
2. It must not result in reduction of tax
3. It must not create another set of exemption other than intended under Article 281 of the Directive
4. It must not create another tax with the characterization of turnover tax in breach of Article 401
5. It must not conflict with state aid rules or other governing legislation while at the same time keep in mind the think small first principle.

As long as it conforms to the above points, the different main approach, that can be implemented independently or in combination for best results are listed in the table underneath.

<b>Special schemes for SMEs</b>	<b>Simplification methods without exempting the SMEs from VAT</b>
General exemption Scheme	Cash flow accounting
The common flat rate scheme	Relying less on invoices
The VAT equalization scheme	Softening reporting obligations
The gradual tax relief scheme	Simplifying rates

Since all the approaches discussed in this paper have its own merits and demerits, it is not possible to absolutely conclude one approach is better than all the other. For example, from the perspective of cascading the flat rate scheme might be better. Nevertheless, from the perspective of simplicity general exemption might be advisable. From the perspective of taxing similar goods similarly, neutrality and fair competition, the simplification approaches that do not exempt SMEs from VAT might be preferable. However, from the perspective of administrative burden on the tax Authority

<sup>189</sup> Report from the Commission to the Council and the European Parliament Minimizing regulatory burden for SMEs Adapting EU regulation to the needs of micro-enterprises, Brussels, 23.11.2011 COM(2011) 803 final p.4

general exemption might be preferable. Zero rating might be good for observing the right to deduct and the effectiveness of the tax system. However from the perspective of reduction of the Community own resource, exemption without the right to deduct might be better. Further, even if the Special treatment might be in accordance with legal neutrality it might not be the case for pure economic neutrality.

Hence, in the end among other issues for considered, there is always the task of balancing between right to deduct, fairness, neutrality, fair competition, effectiveness and taxing similar goods similarly. In the process, one might be undermined compared to other. It is submitted that, the approach choice for special treatment of SMEs depended on from which perspective it is being analyzed. However, permitting all the Member States to pick the one they favor will result in different priorities undermining harmonization. Therefore, it is advisable to design on EU level simplification approach and definition of SMEs that can be implemented similarly by all Member States according to the subsidiarity principle. Finally, yet importantly, it should be noted that the difficulty of negotiation to reach into unanimous treatment of SMEs requires the Member States to have patience and willingness to forfeit for the sake of building harmonized single market.

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