Basic Features of VAT

Part Three.

Tax on consumption idea and territorial connection

The directives issued at European level understand *VAT explicitly as a consumption tax*. The common VAT system is based on the principle that taxation takes place in the country of actual consumption.

The concept of consumption is, however, indefinite. *The VAT Directive does not contain an explicit definition of terms*. The Excise Duty Directive does not (directly) apply to VAT. From an administrative point of view, it is practically impossible to link VAT directly to consumption. *Turnover as an act of commercial transactions*, on the other hand, is much *easier to record and control* due to the associated cash flows compared to consumption. In terms of the collection technique, the VAT system is therefore linked to the turnover of taxable persons (entrepreneurs). Sales are:

- the delivery of goods;
- the provision of services;
- the importation of goods from third countries into the Community;
- the intra-Community acquisition of goods supplied from another Member State.

Deliveries and services are generally *only taxable if they are based on a legal transaction* that links performance and remuneration. In contrast, *the taxation of imports* is *independent of a "sale for export* to the customs territory of the Community", ie

independent of an underlying legal transaction (purchase contract, work and work delivery contract, etc.).

Regardless of its technical connection with commercial transactions (sales), the ECJ has consistently ruled on the *character of value added tax as a general consumption tax*. The interpretation of the sales tax regulations must therefore teleologically be based on the *consumption tax concept*. The OECD also continually emphasizes the consumption tax concept of VAT and the importance of its consistent application in international business relationships.

In cross-border situations, the consumption tax character of VAT is particularly important for the *division of national taxation rights*.

The place of performance is initially the most obvious territorial connection point for VAT. The state in whose territory the *place of performance is located* has *the right to tax the performance*. The place of performance thus represents the *connection between the tax object (turnover) and the national legal system* and is the result of the principle of territoriality. For delivery *transactions across the border*, *the place of consumption* is usually not at the place of delivery (country of origin), but in *the country of destination*. In cross-border deliveries between companies, the VAT system therefore essentially follows *the destination principle*. The country of destination principle is implemented with the help of the tax exemption for export or for intra-Community delivery in the country of origin and the tax liability for import or for intra-Community acquisition in the country of destination in accordance with the tax rates there.

The place of delivery has two functions in this context: On the one hand, it *grants control powers to the tax authorities* in the delivery country. On the other hand, it should *ensure the relief of the items from any sales tax in the country of origin*. Because the delivery is deemed to have been made in the country of origin, it can be "real" - i.e. *with input tax deduction* - exempt from sales tax. *All transactions carried out in the country of origin remain neutral in the VAT result.*

The right to tax in the country of consumption is exercised through the taxation of the import corresponding to the export delivery or the intra-community acquisition associated with the intra-community delivery. Due to the importation or the intra-community acquisition, the goods arrive in the country of destination for sales tax purposes. The subsequent sales are also subject to the regulations of the country of destination.
Example: A Hungarian trading company purchases goods from the Far East and other EU countries and sells these goods on from its business premises. *The sales following import and intra-Community acquisition are taxable as deliveries in Hungary*.
Only sales carried out in the respective inland are subject to the national VAT regime of a specific country.

However, this may not fully apply to import VAT, which standardizes the place where the customs debt arises and contains fictions, also applies accordingly to the EU Tax in accordance with Section 21 (2) German UStG. After that, it is quite possible that the *VAT is incurred in a Member State other than that of the importation.* This becomes very clearl in the case of *import smuggling*. According to this, the place of origin of the customs debt

is always the place in whose Member State the smuggling is found, regardless of the Member State in which the smuggling was committed.

For the correct treatment of services in international contexts, it is imperative to determine the location from the point of view of sales tax law. From a geographical point of view, the *place where a supply is relevant for VAT rarely coincides with the place where the supplier actually operates*.

If the place of performance is not in Hungary, it is deemed to have been provided abroad. If a service is assessed as non-taxable foreign sales under domestic VAT law, this often leads to the company making domestic sales abroad and thus falling under the local VAT system. This is particularly the case within the EU, since the provisions on the location of services are coordinated between the EU member states. *The declared aim of the common VAT system is to avoid both non-taxation and double taxation*. If the place of performance is abroad, this can trigger the obligation to register and / or to appoint a fiscal representative according to foreign law, depending on the type of turnover and country. The domestic sales tax law, on the other hand, cannot postulate any taxability abroad. Neither can it be ruled out that, given taxability domestically, the same service is simultaneously subject to a foreign VAT regime.

Example: A German company buys trade goods in Denmark in order to resell them in Denmark as well. From a German perspective, the process is not VAT taxable. However, the process is subject to Danish VAT law.

As *experts in VAT law* we are ready to work with you. ***Get in touch!***

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