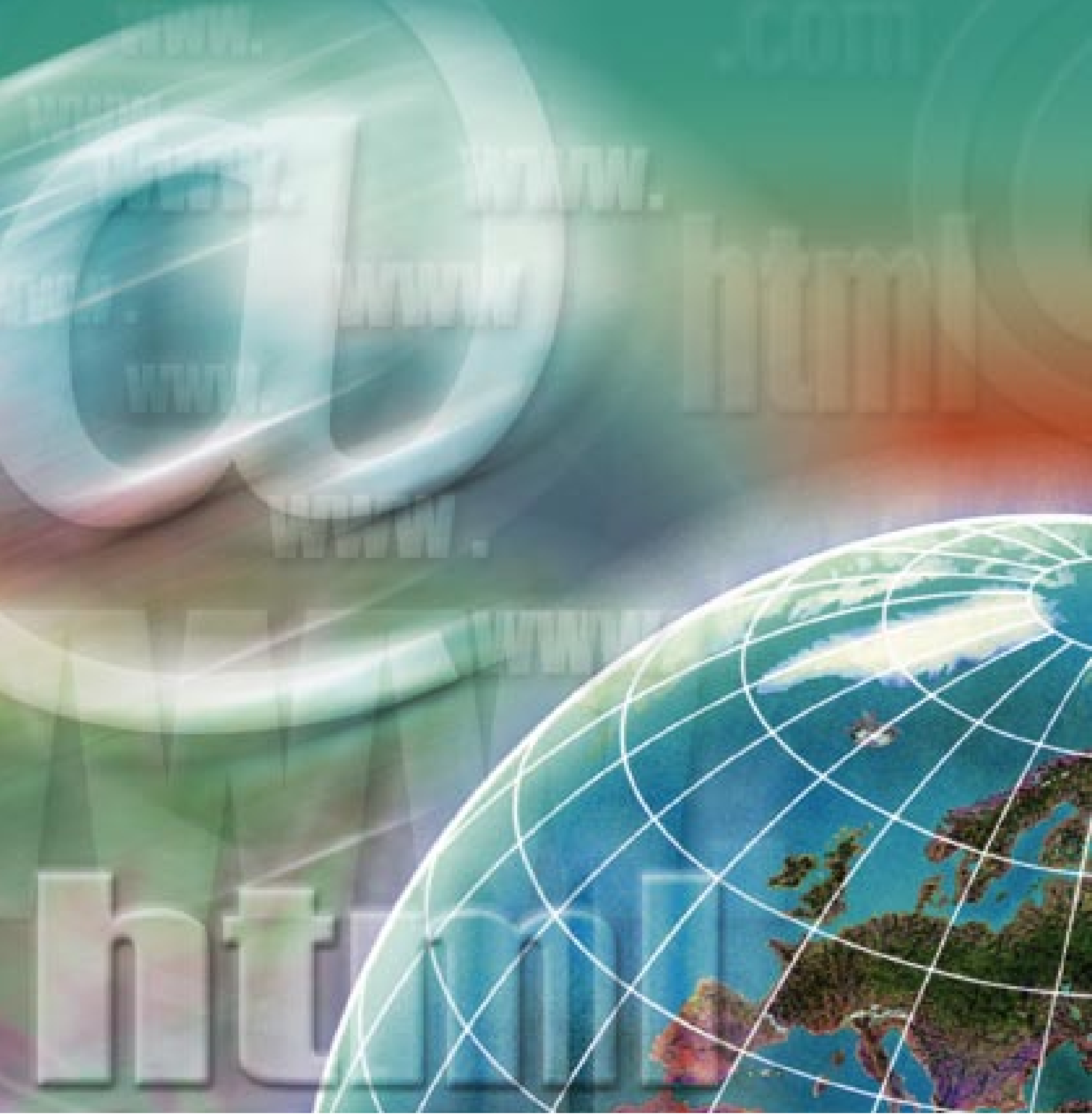

NAO

National Audit Office

HM REVENUE & CUSTOMS
VAT on e-commerce
Additional Background Information

CONTENTS

METHODOLOGY 3

OECD WORK ON THE TAXATION OF E-COMMERCE 7

The Taxation Framework Conditions – Principles 7

OECD Research and publications 7

Further work by the OECD 9

THE DEPARTMENT'S APPROACH TO ASSESSING THE RISKS OF NON-COMPLIANCE ON VAT INCLUDING E-COMMERCE 10

AREAS OF THE DEPARTMENT RESPONSIBLE FOR THE RISK AREAS COVERED IN THIS REPORT 12

GLOSSARY 14

METHODOLOGY

The study objective was to examine whether HM Revenue & Customs has responded appropriately to the risks to the assessment and collection of VAT from e-commerce.

Analysis of data on the growth of e-commerce

1 We analysed external sources of data to identify trends in e-commerce sales to UK customers and the sectors where most trade is carried out e.g. music. These included:

- Office for National Statistics (www.statistics.gov.uk) produces an annual e-commerce survey on the value of electronic trading covering the non-financial sector. It surveys 9,000 UK businesses of all sizes and covers most economic activity.
- Mintel (www.mintel.com) publishes Internet Quarterly. It is a global supplier of consumer, media and market research. Mintel uses a sample of internet users to identify how often they use the internet, how, when and where they access it, what they use the internet for including what they purchase and who is most likely to make purchases.
- IMRG (Interactive Media and Retail Group) (www.imrg.org) published the Fifth Anniversary Special report and Five Year Forecast in 2005. IMRG was formed in 1990 to support the needs of the online retail industry. Its report includes a five year forecast up to 2010 of retail e-commerce activity. More than 80 retailers contributed data.

Analysis of data held by the Department

2 We sought to collect data from the Department on:

- The amount of VAT collected from e-commerce businesses.
- The level of compliance by e-commerce businesses paying over VAT.
- Its estimates of the losses to VAT from non-compliance.
- The resources it has allocated to tackling non-compliance on e-commerce given its other priorities.
- The cost effectiveness of its methods for detecting non-compliance of businesses involved with e-commerce.

3 We found that the Department does not separately identify the exact amount of VAT collected from e-commerce because businesses are required to calculate and pay over VAT for their entire taxable activities, which include both traditional forms of business and e-commerce. We therefore used the Department's estimate of the percentage of retail transactions which were carried out over the internet to arrive at the amount of VAT that could potentially be involved.

4 The Department does not calculate the level of non-compliance by e-commerce businesses as a sector but reviews the risks within its overall approach. As part of its overall approach the Department has identified four main areas of loss including general trader non-compliance; VAT avoidance; losses from the shadow economy and VAT missing trader fraud which it uses as the basis for allocating resources to the risks. On the failure of e-commerce businesses to register for VAT we were able to analyse the Department's data on the number of cases detected; the amount of VAT involved and the difficulties faced by the Department in investigating these cases. We also examined how Web Robot is likely to improve the Department's performance in detecting these types of cases.

Review of the Department's approach to assessing risks and detecting non-compliance

5 We employed a consultant with expertise in examining risk management systems, Louise Bennett from Vivas Ltd. She examined the Department's overall approach to assessing whether it collects the right amount of VAT and whether this included an assessment of the risks to VAT from e-commerce businesses. She reviewed the Department's approach to assessing the risks in the large business population which included examining 13 strategic assurance audit plans prepared by the Department on large businesses across five industry sectors (car manufacturers, retail, e-tail and mail order; the financial sector and the music industry). She also examined the Department's approach to assessing the risks to VAT from small and medium enterprises. To do this work she interviewed senior officials in the Department responsible for the Department's risk assessment programme and reviewed key documents.

6 To determine how the Department detects businesses which should be registered for VAT, we interviewed a range of Departmental staff including staff in the Joint Shadow Economy Team in Salford responsible for developing guidance and detecting e-commerce businesses which should be registered for VAT and staff responsible for developing and piloting the Web Robot.

Comparisons with the approaches used by other tax authorities

7 We identified practices used by other tax administrations to assure the revenue from businesses including Sweden, the Netherlands, Australia and Canada. We collected key information from them on their approach to assessing the risk; the main risks they have identified and the significance of the risks on e-commerce in the context of the other risks they are tackling; the methods they use to detect non-compliance by e-businesses and their plans for the future. We also discussed with each of the Audit Offices in these countries relevant work they have undertaken.

Semi-structured interviews and a review of key documents

8 We held discussions with the Department, European Commission (www.europa.eu) and OECD (www.oecd.org) on:

- The changes being proposed to ensure that VAT is collected on intra-community supplies of e-services from businesses to customers.
- The operation of European Community reliefs on goods imported into the EU, and the practicalities of implementation.

9 We also reviewed key documents such as the European Commission's proposals on changes to VAT on e-services; the results of its consultations with businesses; the OECD documents on the taxation of e-commerce including its book on Taxation and Electronic Commerce – *Implementing the Ottawa Taxation Framework Conditions* ISBN 92-64-18595-X.

Views of external stakeholders

10 We contacted stakeholders to understand their views on VAT and e-commerce transactions. The organisations contacted included those below which formed part of our advisory group; The States of Guernsey Government and the States of Jersey Government; the Forum of Private Business (www.fpb.co.uk) which represents the interests of approximately 25,000 small and medium-sized businesses based in the UK, and eBay (www.ebay.co.uk).

Advisory group to the NAO study team

11 We set up an advisory group to provide advice and feedback on the study at key stages. The meetings considered the scope and issues of the study, our plans for the work such as whether there were additional sources of information we could obtain and the findings and conclusions from our work. Membership of the group includes representatives from:

- British Association of Record Dealers (www.bardltd.org) which represents specialist, multiple, internet and independent retailers who sell entertainment products such as music, DVDs and multimedia games as well as wholesalers;
- British Retail Consortium (www.brc.org.uk) which represents a range of retailers from the large multiples and department stores to independents selling a wide selection of products in town centres, out-of-town, rural and virtual stores;
- Chartered Institute of Taxation (www.tax.org.uk) the leading professional body in the United Kingdom concerned solely with taxation;
- HM Revenue & Customs;
- Institute of Chartered Accountants in England & Wales (www.icaew.co.uk) the largest professional accountancy body in Europe;
- Internet Service Providers Association (www.ispa.org.uk) the UK trade association for providers of internet services; and
- VAT Practitioners Group (www.vpgweb.com) representing advisers on VAT matters.

OECD WORK ON THE TAXATION OF E-COMMERCE

The Taxation Framework Conditions – Principles

Neutrality – Taxation should seek to be neutral and equitable between different types of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

Efficiency – Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

Certainty and simplicity – The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted for.

Effectiveness and fairness – Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counter-measures proportionate to the risks involved.

Flexibility – The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

Source: OECD

OECD Research and publications

Taxation and Electronic Commerce: Implementation of the Ottawa Taxation Framework Conditions: May 2001

The 1998 Ottawa Taxation Framework Conditions provide that rules for the consumption taxation of cross-border electronic commerce should result in taxation in the jurisdiction where the consumption takes place. Although this principle is conceptually straightforward its application can raise difficulties in practice. For example, the tax administration in the country where the customer is located may encounter difficulties in ensuring that the right amount of tax is collected and remitted given that there may be no jurisdictional relationship between the administration and the supplier. Similarly the supplier may have difficulty in complying with the tax rules of the country where the customer is located. The report recommended a number of ways in which implementation of the principle might be achieved.

Implementation of the Ottawa Framework Conditions: The 2003 Report

The report provides an overview of the work of the OECD and highlights further work to be done. It considered a range of issues on taxpayer service; tax administration, identification and information needs; tax collection and control; consumption taxes and international tax arrangements and co-operation. On consumption taxes, the OECD covered:

- The place of taxation issues including definitions of place of consumption for business-to-business transactions and business-to-consumer which had been agreed and published.
- Guidance issued on methods for verifying jurisdiction and status of customer.
- Recommended approaches to effective administration and collection of tax.

Electronic Commerce: Facilitating Collection of Consumption Taxes on Business-to-Consumer Cross-border E-Commerce Transaction: OECD February 2005

The report focuses on the collection of consumption taxes on cross-border business-to-consumer e-commerce transactions. It encourages governments to consider the requirements it places on intermediaries to act on behalf of taxpayers, noting that if more countries adopt a requirement for overseas suppliers to account for value added taxes, intermediaries may well have an increased role to play.

Further work by the OECD

In February 2006 the OECD announced a new project aimed at providing guidance for governments on applying VAT to cross-border trade. Pending completion of this project, OECD countries have agreed on two fundamental principles for charging VAT on internationally traded services and intangibles:

- For consumption tax purposes internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption.
- The burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation.

The proposed guidelines are needed in the light of rapidly increasing international trade, particularly in the area of services and intangibles, because a current lack of international "rules of the game" can lead to double taxation or unintentional non-taxation.

THE DEPARTMENT'S APPROACH TO ASSESSING THE RISKS OF NON-COMPLIANCE ON VAT INCLUDING E-COMMERCE

1 In 2003 and 2004 the Department assessed the risks of VAT loss across 40 different trade sectors and sub-sectors including banking, utilities and transport. As part of its work, the Department assessed the relative risks across the sectors to prioritise the areas where it needs to concentrate its checks. It made assessments against each main area of loss in the Department's VAT Compliance Strategy (Figure 4 in the main report) ranging from very high risk to very low risk. Within its analysis of the trade sectors, the Department identified the risks of loss on e-commerce activities, which mainly concentrated on the e-tailing and mail order sector. This sector includes businesses selling goods through the internet such as large business retailers which have set up separate businesses to sell goods through the internet including some major supermarkets as well as traditional mail order companies. In 2004, the Department rated the risks to VAT in that sector as low or very low against each of the main areas of loss in the VAT compliance strategy. This is because internet sales of UK based retailers represent a small percentage of their total business and the amount of VAT at risk is likely to be relatively low as a consequence.

2 Alongside the Department's risk assessment by trade sector, it also conducts further risk assessments in two groups:

- The 1,000 businesses that pay the most VAT which are examined by the Department's Large Business Service; and
- The remaining 1.8 million registered businesses which are examined by the Department's National and Local Compliance teams.

3 In assessing the compliance of businesses to ensure they pay the correct amount of VAT, the Department's Large Business Service prepares a strategic assurance plan for each business. This covers an assessment of the risks of revenue loss against a standard set of criteria including trends in VAT paid; current disputes; litigation; company accounting systems; an analysis of VAT risks within the trade sector and a plan for the Department's audit of the company's VAT. The plans also take account of the trade sector analysis. We examined a sample of 13 strategic assurance plans covering five industry sectors and found that the Department had identified the risks from e-commerce in seven of these plans. E-commerce was not a significant factor in the other six plans. The e-commerce risks identified by the Department occurred mainly in the retail sector. However the risk of these retailers paying over the incorrect amount of VAT is low. This is because their website operations are part of their overall business with transactions passing through the same accounting system as those for their established high street stores. Where this is not the case, they have set up separate businesses with well tested systems.

4 For the remaining 1.8 million registered businesses the Department's National Compliance branch undertakes a two-tiered risk assessment to determine which businesses need to be checked. A central risk assessment is conducted on all of these businesses to allocate businesses to six different groups prioritised by risk ranging from exceptional risk to low risk. The central risk assessment takes account of a number of factors including the business and its complexity; results of previous checks by the Department and the track record of the business in paying the correct amount of VAT on time. The Department's National Compliance risk branch then conduct a more detailed local risk assessment based on information they hold on the compliance record of local businesses to decide which should be contacted for further checks.

5 Local Compliance branches also carry out projects called "test drills" to examine potential new risks which could result in VAT losses and to test methods for reducing those risks. The results of the work are disseminated nationally. Local Compliance branches are currently carrying out two projects examining e-commerce. One of these projects focused specifically on the level of risk to the collection of VAT posed by certain businesses trading on the internet and tested the Department's techniques for checking the amount of VAT collected from individual businesses. A further project is examining the compliance of businesses operating on the internet for both direct and indirect taxes.

AREAS OF THE DEPARTMENT RESPONSIBLE FOR

HM Revenue & Customs

Operations
This covers the vast majority of the Department and focuses on delivering high quality, cost effective services. The core activities are:

- Delivering customer contact, processing and operational compliance;
- Delivering enforcement capabilities; and
- Debt management and banking

Product and Process Groups
Products can be defined as taxes, duties, credits and benefits. Processes are the schemes by which products are delivered. The Groups are responsible for the design, specification and providing advice and will carry out technical policy work liaising with HM Treasury and Ministers.

Customer Units
Responsible for identifying and understanding the requirements and behaviours of customers, and the risk associated with them so that HMRC:

- Makes it easier for customers to comply;
- Improves the customer experience;
- Improves compliance; and
- Reduces the cost of compliance.

THE RISK AREAS COVERED IN THIS REPORT

The risks to VAT from the growth in e-commerce and compliance of registered and unregistered businesses

National Compliance
Supports the various compliance strategies through a number of teams with a national focus. The relevant one here looks at national and operational risk, with responsibility for drawing up and maintaining the national risk picture across HMRC and managing operational risk.

Local compliance
Responsible for locally delivered operational compliance work across a range of business taxes and duties, including Corporation Tax, Employer Compliance, PAYE, VAT, Excise, International Trade and other business taxes.

Large Business Service
Delivers the compliance and customer relationship activity for large businesses. It is arranged around industry sectors and provides a single point of contact for each business.

The risks to VAT from supplies of e-services and proposed future developments

Corporation Tax and VAT
Responsible for optimising the design, owning the specification and providing advice across Corporation Tax and VAT. It works with others to support operational plans and compliance strategies and to deliver new policy and policy changes. The VAT place of supply policy falls within the remit of CT and VAT.

The risks to VAT from goods ordered over the internet from outside the EU

Frontiers, Strategy and Policy Development
Addresses the needs and risks of individuals and organisations moving goods across borders. This includes international trade and security and anti-smuggling.

GLOSSARY

Auction sites	A place where individuals and businesses can buy and sell items. All transactions and payments take place online using card payment systems or bank transfers. These sites allow customers to bid for items on offer within a fixed timeframe and constraints.
Customs Freight Simplified Procedures (CFSP)	A procedure that allows "authorised traders" to remove goods from the frontier to business premises for clearance and release by making simplified declarations electronically. The business makes a fiscal and statistical declaration at a later specified date. The Department may subsequently carry out checks to confirm the procedure is being operated satisfactorily.
Commercial consignments	Goods supplied by a business based outside the EU and imported by a private person in the UK.
Derogation	In certain circumstances a Member State can request the European Commission to grant an exception to the VAT rules.
Digitised products	Items that can be delivered in a digital format, for example music and video clips that can be downloaded directly to a PC or other digital device.
Digital Certificate	A unique set of numbers that has been generated by a trusted company – but only once it has been established that the company is legitimate and authentic. The company can use this certificate to provide authentication (that it is who it claims to be) and set up a secure website to accept payments online.
Domain registrar	Such as WOHIS and Checkdomain.com register website addresses and ensure that no two separate independent businesses have the same website address. Entries on the site contain information about the domain name and who it is registered to.

e-Marketplaces	A website where individuals and businesses can buy and sell items in an auction or for a fixed price. All transactions and payments usually take place online using card payment systems.
European Community reliefs	Allow relief from import VAT and Customs Duties for small packages, which arrive from a country outside the EU, valued up to a certain amount. The rates differ for commercial and gift consignments and are currently set at £18 and £36 respectively in the UK.
Geo-location software	Software that can pinpoint the country where a computer is located. It can be used to determine the location of customers when considering in which jurisdiction tax is due. It can also be used for advertising, sending specific adverts to customers in a chosen town or country.
ICANN	Internet Corporation for Assigned Names and Numbers is an internationally organised, non-profit corporation that has responsibility for Internet Protocol (IP) address space allocation, protocol identifier assignment, generic and country code top-Level Domain name system management, and root server system management functions.
Import VAT	VAT chargeable on goods imported into the UK from outside the EU.
Internet Service Providers (ISPs)	An organisation that provides internet access to users. Most ISPs provide this as part of a package which can also include email, websites for users, news and advertising.
Joint Shadow Economy Teams (JoSETs)	Specialist teams made up of HM Revenue & Customs staff and staff from the Department for Work and Pensions. These teams identify businesses that have failed to register when they should for one or more of the following taxes: VAT, Income tax, PAYE or are committing benefit fraud.

One-Stop-Shop

The "One-Stop-Shop" proposal published by the European Commission in 2005 includes a system that will allow businesses to comply with their VAT obligations in a number of Member States through a web-based form hosted by their tax authority. It will also allow a Member State's tax authority access to VAT, business and transactional information in real time across all Member States.

Shadow Economy Teams (SETs)

Specialist VAT teams that identify businesses that have failed to register when they should.

Special Territories

Countries or areas that are part of the customs territory of the European Community but not part of the fiscal (VAT) territory. VAT is due on imports from these territories. Except Andorra and the Channel Islands each of the territories belongs to a different Member State. These include Finland – Åland Islands, Spain – Canary Islands, Greece – Mount Athos; France – French Guiana, Guadeloupe, Martinique and Reunion. Goods entering the UK from these territories are treated as imports for VAT purposes rather than acquisitions from another EU Member State.

The Domain Name System

The Domain Name System (DNS) helps users find their way around the Internet. Every computer on the Internet has a unique address called its "IP address" (Internet Protocol address). Because IP addresses (which are strings of numbers) are hard to remember, the DNS allows a familiar string of letters (the "domain name") to be used instead. So rather than typing "192.0.34.65," you can type "www.icann.org."

Tracking Software	Software that can be used to track online transactions.
VAT on e-Services System (VoeS)	Introduced following the changes in July 2003. This allows a non-EU based business to register with one tax authority within the EU and pay the VAT due in all Member States where the business has customers. Under this scheme all transactions are subject to VAT. There is no registration threshold.
Web Robot	An advanced search engine that helps the Department produce information on areas of internet activity.
Zero-Rated	A rate of UK VAT, fixed at zero percent, applied to certain specific items allowing relief in areas essential for life such as certain food stuffs, children's clothing, books, etc. Exports are also zero-rated. This allows the VAT registered business to claim back any relevant input VAT.