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HM REVENUE & CUSTOMS

VAT on e-commerce

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 1051 Session 2005-2006 | 26 May 2006

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LONDON: The Stationery Office
£6.75

Ordered by the
House of Commons
to be printed on 22 May 2006

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This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

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18 May 2006

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EXECUTIVE SUMMARY

The growth in e-commerce and the effects on VAT

1 The value of internet sales, or e-commerce **(Figure 1)**, in the UK more than trebled between 2002 and 2004. We estimate that in 2005-06 HM Revenue & Customs (the Department) collected over £1 billion in VAT on e-commerce goods and services. 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.

1 What is e-commerce?

E-commerce is the term used to describe the ordering of goods and services using the internet. Transactions over the internet may be conducted business-to-business or business-to-customer. Businesses supplying these goods and services may be in the UK, other EU Member States or elsewhere in the world.

The features of e-commerce, which distinguish it from traditional commercial activity, are that the marketing of goods or services is carried out through a website where customers and businesses can browse online catalogues and use "online-shopping cart" systems; place orders via interactive online order forms; and pay by credit and debit cards. The websites are available 24 hours a day. Around 22 million Britons shopped online in 2005.

Source: OECD and National Audit Office

2 Generally, businesses trading above the VAT registration threshold of £60,000[1] a year charge VAT on goods and services they supply and offset the VAT they have incurred on their own purchases. The tax is therefore ultimately borne by the end-consumer. In this report we use the term 'customer' to refer to the end-consumer. Sales over the internet to UK non-business customers increased from £6.4 billion in 2002 to £18.1 billion in 2004[2], with a further surge around Christmas 2005. These sales are expected to rise to nearly £60 billion a year by April 2010[3]. The proportion of VAT collected by the Department that relates to e-commerce transactions is also therefore likely to grow substantially.

3 Most sales over the internet are for goods, including goods traditionally sold by mail order companies such as books, electrical equipment and clothes. Around 71 per cent of spending online was on goods in 2004. Sales of books and most food are zero-rated and do not attract VAT, whereas most other goods and services are subject to VAT **(Figure 2)**. Services purchased online such as flights and holidays represented 26 per cent of the total spent in the UK. Some services can be provided to the customer almost instantaneously, for example by downloading digitised products such as computer software, music and electronic books. Sales of digitised products represented a further 2 per cent of sales in 2004[4].

1 £61,000 from April 2006.
2 Information and Communication Technology (ICT): Activity of UK Business 2004: Based on the confidential results of the 2004 e-commerce Survey of Business covering the non-financial sector – Office for National Statistics.
3 Interactive Media in Retail Group 5th Anniversary Special Report and 5 Year Forecast – 2005.
4 The percentages in paragraph 3 do not total 100 per cent because of rounding.

2 The percentage of internet users making purchases of different types of goods and services from websites in the three months up to November 2002 and April 2005

	November 2002	April 2005	% point change Nov 2002 – Apr 2005
Base: Internet users aged 15+	853	1,339	
	%	%	
Books*	18	19	+1
Video/DVDs	13	14	+1
Entertainment tickets	11	14	+3
Music	9	11	+2
Computer software	8	9	+1
Clothing and footwear	8	12	+4
Computer hardware	8	9	+1
Supermarket or grocery store*	6	7	+1
Toys and games	5	5	–
Gifts e.g. flowers, confectionery	5	8	+3
Electrical goods	5	7	+2
Auction site	5	15	+10
DIY and garden products	3	5	+2
Home furnishings	2	5	+3
Toiletries/cosmetics/fragrances	2	2	–
Motoring	1	3	+2
Adult entertainment	1	1	–
Travel only	–	21	–
Holiday only	–	11	–

* Goods such as books and most food are zero-rated for VAT purposes.

Source: MORI/Mintel Internet Quarterly June 2005

NOTE

The percentages show the proportion of the total users making a purchase. For example 14 per cent of the users surveyed had purchased videos or DVDs over the internet in the period up to April 2005.

The scope of this report

4 UK businesses are selling an increasing proportion of their goods and services online. Cross-border trade has also increased as customers have been able to identify suppliers, anywhere in the world, offering a greater choice of merchandise and competitive prices. The ease of setting up businesses online and the greater choice for retail businesses in where they locate, with no need to have a physical presence on the high street, could make it more difficult to trace suppliers and collect VAT. Against this background, this report examines the implications of the growth in e-commerce for VAT and how e-commerce features in the Department's approach to assessing and collecting VAT (Part 1). It also examines the risks involved in the following areas, and how the Department is tackling them:

- e-commerce businesses failing to register for VAT when they should (Part 2);
- goods ordered over the internet from outside the European Union (Part 3);
- supplies of e-services (Part 4).

5 Details of our methodology are in the attached booklet.

Main findings and conclusions

6 Since the 1990s the Department has been working closely with the European Commission and the Organisation for Economic Co-operation and Development (OECD) to assess the implications of the growth in e-commerce especially cross-border trade on the collection of VAT. The Department's view is that, despite the growth, VAT on e-commerce still amounts to only a small proportion of total VAT collected and that most e-commerce trade to UK customers is by UK-based businesses. As such, most of the VAT payable on e-commerce is covered by the Department's well-established assurance arrangements for ensuring UK businesses register and pay the VAT due. These arrangements cover businesses' entire taxable activity, whether in traditional form or e-commerce, and involve assessing the risks of non-compliance by different businesses and more detailed checks on selected businesses.

7 The Department's judgement that the overall risk to VAT revenue from e-commerce is currently low appears reasonable. While it is difficult to validate in terms of firm data on the actual amount of VAT collected from e-commerce, we found that other tax authorities have drawn similar conclusions on the overall level of risk. The Department has been alert to specific areas of risk which have emerged including the failure of e-businesses to register for VAT and the non-payment or underpayment of import VAT when due on goods ordered from outside the European Union (EU). A further area of risk identified is the possible erosion of VAT revenues with the growth in supplies of electronic services to UK customers from businesses outside the UK, and from UK businesses relocating to other EU countries with lower rates of VAT. As activity increases in this fast changing environment, it will be important that the Department builds on the work already done to keep abreast of possible changes in the patterns and levels of risk to VAT.

8 On failing to register and pay VAT on e-commerce, the main risk lies with businesses trading solely on the internet and e-marketplace traders (where a number of traders offer goods and services on a website at a fixed price and/or by inviting bids) rather than businesses which have introduced online operations alongside their existing business. The Department's work in detecting all types of business operating in the shadow economy has indicated that to date e-businesses present lower risks to VAT than other types of businesses that fail to register because on average the amount of VAT involved is lower. The Department has been undertaking detailed work to understand the characteristics of businesses that fail to register to help target its detection efforts. It is developing innovative detection methods such as Web Robot, an advanced search engine which can search the World Wide Web to identify websites and businesses that match particular profiles. Web Robot should assist the Department in carrying out more extensive and cost effective checks to ensure those selling on the internet are registering for VAT when required to do so. The Department's education campaigns will also assume greater importance in helping the growing number of people who trade on the internet to understand their tax obligations.

9 On the payment of import VAT on goods ordered from outside the EU, some suppliers incorrectly describe or value the contents of commercial packages to take advantage of UK reliefs exempting from import VAT consignments valued below £18 or to reduce the amount of VAT due. While it is difficult to quantify the extent to which overseas suppliers seek to evade VAT on behalf of the recipient in this way, controls operated by Royal Mail and express carriers together with the Department's selective checks provide a safeguard which the Department views as proportionate to the VAT at risk. It could do further work to confirm that this remains the case. The Department is increasingly working in partnership with overseas organisations to operate checks at the point of dispatch on goods which are liable for import VAT. This is a more cost-effective way of ensuring the payment of import VAT, compared with operating checks at the time of importation into the UK. The Department has also run publicity campaigns to inform UK shoppers of the import VAT due on consignments ordered over the internet and these will assume greater importance if the growth in trade continues.

10 Around 45 million small commercial consignments are imported by post into the UK each year. Around half of the sales by value are from the Channel Islands where some UK-based retailers have set up business operations to take advantage of the UK reliefs in selling goods to UK customers ordering online. The Department accepts that the VAT reliefs may be claimed on this trade provided the goods are supplied by a business established outside the EU, and are imported by a private person or a business that is unconnected with the supplier. In Budget 2006 the Government announced that it is keeping under close review the way in which some UK businesses have restructured their activities to take advantage of the VAT-relief that applies to commercial consignments imported from outside the EU and will consider options for changing the relief if it continues. The States of Jersey Government has recently announced measures which are being implemented to curb the trade by UK-based retailers.

11 On the possible erosion of VAT revenues on electronic services, the UK has worked with the European Commission and other Member States to tackle the distortion to competition caused by the place of taxation rules for VAT. There are currently different rules depending on whether services are provided to UK customers from the UK, from elsewhere in the EU or from outside the EU. Before July 2003 businesses located outside the EU could sell e-services to customers within the EU without charging VAT. Temporary changes in EU legislation which came into force in July 2003 removed some of the distortion by changing the rules so that e-services provided to EU customers by businesses outside the EU are now subject to VAT. EU Member States have no legal status to enforce their tax regimes in non-EU countries. Nevertheless the Department has collected £59 million more in VAT (up to December 2005) from businesses based outside the EU supplying e-services to UK customers. The Department should explore further ways of establishing the extent to which all relevant businesses are complying.

12 A further concern has been the risk of EU businesses relocating to certain other EU Member States to benefit from lower VAT rates on their sales of e-services to EU customers. The Commission issued a further proposal in July 2005 which, if adopted, would make the 2003 changes permanent and would also change the way in which intra-EU supplies of e-services are taxed so that VAT would be due in the Member State where the customer uses the service. This is consistent with the UK view that tax should be due in the place of consumption and this proposal was a priority for the UK during its Presidency in the second half of 2005. If these changes are adopted, the Department would need to work with the European Commission, other Member States and the business community to implement systems that are effective in collecting the tax due and are easy to use, and provide businesses with easy access to information and guidance on their tax obligations.

Recommendations

13 Our recommendations are designed to help the Department as e-commerce grows and it develops its approach and methods for tackling non-compliance.

On understanding the risks to VAT from the growth of e-commerce and whether its response is appropriate, the Department should:

- continue to update its understanding of where the losses are occurring and estimate the amounts involved, including estimating the overall level of misdeclaration on commercial consignments of goods arriving in the UK;
- using those estimates, re-assess whether it has allocated the right level of resources to tackling non-compliance in the areas of risk identified;
- evaluate the cost effectiveness of its methods for detecting non-compliance on e-commerce.

On the potential failure of e-businesses to register for and pay VAT, the Department should:

- encourage e-marketplaces to identify those businesses trading on their websites where turnover exceeds the VAT threshold and to advise those businesses to register if they have not already done so;
- further develop and make full use of various tools such as Web Robot to increase the number of businesses it detects as having failed to register for VAT; and
- continue the checks on the compliance record of businesses previously detected and now registered to pay VAT, with exception reports to highlight either those failing to pay or file returns or applying to deregister when they should not.

On the purchase of goods from businesses located outside the EU, the Department should:

- increase publicity campaigns on the internet and through other media to inform UK customers of their liability for any tax due; and
- ensure that in practice overseas organisations provide adequate assurance that they have operated in accordance with the new agreements for assessing and paying VAT due.

On VAT on e-services supplied from outside the EU, the Department should:

- explore how to identify those non-EU businesses that supply UK customers and should be registered in the EU to pay VAT, working with tax authorities in other Member States where appropriate;
- evaluate the results of the international audit work carried out on businesses registered under the VAT on e-Services System (an EU-wide system which allows non-EU based businesses to register with one tax authority within the EU and pay the VAT due in all Member States where they have customers) and assess the level of audit that needs to be carried out in the future to gain sufficient assurance on their compliance with the VAT requirements;
- seek to extend the exchange of information provisions in existing bilateral agreements between the UK and other countries for direct taxation, to cover VAT and set up new agreements where VAT revenue is at risk.

PART ONE

The risks to VAT posed by e-commerce businesses

International developments in the taxation of e-commerce

1.1 The European Commission has been assessing the effects of the growth of e-commerce on cross-border trade and the collection of VAT. On goods, the Commission has monitored the growing volume of goods purchased by EU customers from outside the EU and raised issues about whether Member States are able to carry out sufficient checks on such consignments at the external borders to ensure VAT is paid when due. On e-services, the Commission has sought to deal with distortions to competition caused by businesses located outside the EU being able to sell e-services to customers within the EU without charging VAT. The Commission has also been assessing the effects on VAT of businesses relocating from within the EU to other Member States to take advantage of lower VAT rates which apply on their supplies of e-services to EU customers. The Department has been similarly tracking these developments and the possible risks to VAT revenue.

1.2 These issues reflected a wider international debate about the taxation of e-commerce transactions leading to an Organisation for Economic Co-operation and Development (OECD) Ministerial Conference held in Ottawa in 1998 on "A Borderless World - Realising the Potential of Global Electronic Commerce". The conference agreed that the key principles that apply to the taxation of conventional commerce should also apply to e-commerce (see the attached booklet). It also agreed that, for cross-border trade, indirect taxation such as VAT should be applied in the country where the goods and services are consumed. After the conference the OECD issued further guidelines to member governments on the taxation of e-commerce. This included recommendations to remove distortions and disincentives to international trade and suggested good practice on the administration of tax. The Department, together with the European Commission and other Member States contributed to the development of this work.

1.3 In line with the OECD's recommendations, the European Commission announced that:

- there should be no new or additional taxes for e-commerce, but existing taxes, including VAT, should be adapted so that they could be applied to e-commerce;
- for VAT, digital products should be treated as supplies of services (the OECD recommendation was that such products should not be categorised as goods);
- supplies of e-services to customers in the EU should be taxed there.

The OECD and European Commission have continued to produce a range of work on the taxation of e-commerce.

1.4 **Figure 3** shows the nature of internet trade between businesses and customers for goods and services in the UK.

HM Revenue & Customs' risk assessment on the level of non-compliance on VAT

1.5 The Department's objective on VAT on e-commerce activities, as with other transactions, is to improve the level of compliance by supporting businesses that comply and to crack down on those which abuse the VAT system. Its VAT Compliance Strategy, launched in 2003, identified four main areas of VAT loss **(Figure 4 on page 10)**.

3 The nature of internet trade between business and customers for goods and services

The Internet and e-Commerce

Connects to the Internet

Internet Service Providers (ISPs)

An individual connects to the internet using an ISP such as AOL, Wanadoo, ntl, Tiscali, etc. In addition to connectivity to the internet these service providers often supply telephone lines, email addresses, personal website space and other information. Some ISPs are providing services from Madeira and Luxembourg to take advantage of lower VAT rates.

Once on the internet

What's available?

Once connected to the internet an individual has a vast amount of information available to them. It is possible to order physical items, receive services or downloads, get quotes, compare prices, bank, etc.

- **Search engines, Comparison sites, Broker sites**
  Sites such as Google, Yahoo! & Lycos allow the individual to search the web using key words or phrases entered. The results are not country specific and suppliers can be based anywhere. Kelkoo, PriceRunner, Moneysupermarket.com and confused.com give the individual access to a large number of prices and products from different suppliers so they can obtain the best deal. Broker sites such as Expedia.co.uk can identify suppliers worldwide that can fulfil the individual's specific requirements.
- **UK suppliers** have either set up separate businesses for internet trading, for example: Tesco, Ocado, etc. or they have set up integrated websites which provide an additional way for customers to buy their products e.g. Marks & Spencer. The top 1,000 VAT paying businesses all have a web presence.
- **Non-UK suppliers** also supply the same goods and services as UK suppliers and these can be accessed via their websites. Any website in the world is accessible from any internet enabled computer terminal. Since July 2003, the Department has collected £59 million (to December 2005) in VAT from non-EU based businesses supplying e-services to UK customers.
- **E-Marketplaces** allow individuals to buy and sell items either through a bidding system or for a fixed price. eBay and Amazon are the main online marketplaces in the UK although there are a number of smaller sites. eBay has over 181 million registered users of its sites worldwide and there are over 78 million items available to buy at any one time.

Ordering goods and services from a website

As they would in a normal store the individual selects items to add to their online shopping cart. Once they have finished shopping and making selections they proceed to the 'checkout'. The individual then provides personal information such as name and delivery address to complete the order. Payment is made via an internet payment provider. Once completed an electronic receipt is emailed to the individual showing details of the items purchased and payment received.

Payment to the website using Internet Payment Processors

Websites make use of such processors to allow payment either via card through VISA, MasterCard or a bank or via online money wallets such as PayPal. The individual enters their personal details, such as name, payment address and card details or in the case of PayPal simply an email address. Transactions are secure and an audit trail of the transaction and all parties involved is created.

Goods dispatched

Delivery

Royal Mail or express carriers such as DHL, UPS, FedEx, etc. deliver items such as DVDs and CDs to the customer. A high proportion of items ordered over the internet from UK businesses are delivered to UK customers directly by the business e.g. food shopping.

Services dispatched electronically

4 The main areas of VAT loss

Failure by registered businesses to pay the right amount of VAT at the right time through genuine mistakes, deliberately understating their sales or falsely inflating the value of purchases to reduce their VAT liability.

Failure of businesses to register to pay VAT where their turnover exceeds £60,000[6] in any 12 month period.

VAT missing trader fraud where businesses register for VAT, buy goods VAT free from another EU Member State, sell them on at VAT inclusive prices and then disappear without paying the VAT due to the Department.

Artificial VAT avoidance schemes which have no business purpose other than to save VAT.

Source: HM Revenue & Customs

1.6 The Department has a well-established and structured approach for assessing the risks of non-compliance which helps to target checks on businesses (see the attached booklet). The Comptroller and Auditor General's Standard Reports on Accounts[5] have examined various aspects of the Department's collection of VAT. In 2003 and 2004 the Department assessed the risks to VAT across 40 trade sectors, covering the whole of the economy including the e-tailing and mail order sector. This sector included large retailers which had set up separate businesses to sell goods through the internet. 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 can include traditional forms of business and e-commerce. In 2004-05 the Department estimated that 95 per cent of retail transactions were by high street stores, 4 per cent by mail order and only 1 per cent over the internet. There are indications that the percentages may have changed in the period leading up to Christmas 2005 with around 9 per cent of retail sales over the internet. At present the Department has rated the risks to VAT in the e-tailing and mail order sector as low or very low against each of its main categories of potential loss. The Department has been recently undertaking work on the level of risks posed by internet trading.

The specific areas of risk to VAT on e-commerce

1.7 Arising from the Department's work it has identified the following areas of risk in relation to VAT on e-commerce:

- businesses operating on the internet may be failing to register for VAT when their taxable turnover exceeds £60,000[6] in any 12 month period;
- suppliers based outside the EU may be incorrectly describing and undervaluing goods entering the country so that they fall below the £18 threshold for UK reliefs on VAT. These reliefs allow goods valued below £18 ordered from businesses located outside the EU to be imported into the UK VAT free;
- the possibility of businesses relocating from the UK to other Member States to take advantage of lower VAT rates which apply on their supplies of e-services to UK customers. The Department estimates that up to £450 million a year in VAT would potentially be collected if all supplies of e-services were liable to VAT in the UK. This is therefore the maximum amount of VAT at risk if all suppliers were to make supplies to UK customers from elsewhere in the EU.

1.8 The tax authorities we contacted in Sweden, the Netherlands, Canada and Australia also rate the tax risks from e-commerce as low at the present time. This is mainly because e-commerce represents a small percentage of economic activity. For example in the Netherlands e-commerce represented just over 2 per cent of retail sales in 2004. Like the UK, these countries regularly monitor the risks to revenue from e-commerce because of the continuing growth in trade, the ease with which e-commerce businesses can move their activites to other countries with lower taxes and the possibility that new risks to tax revenue may emerge. Their risk assessments tend to cover all taxes as a group because for many years they have had a single tax authority for covering direct and indirect taxes. Since the creation of the HM Revenue & Customs in April 2005, the Department has also been developing risk assessments across the different taxes.

5 Section 2 of the Exchequer and Audit Departments Act 1921, as amended by the Government Resources Accounts Act 2000 requires the Comptroller and Auditor General to examine the accounts of the Department on behalf of the House of Commons to ascertain that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and proper allocation of revenue. This approach has addressed risks to revenue in the large business environment (HC 83; 2003-04); improving the compliance in small and medium-sized enterprises (HC 119; 2004-05) and the management of VAT debt (HC 447; 2004-05).

6 £61,000 from April 2006.

PART TWO

Failure of e-commerce businesses to register for VAT

2.1 E-commerce businesses may be failing to register to pay VAT and other taxes, particularly those using e-marketplaces, where a number of traders offer goods on a website at a fixed price and/or by inviting bids. Trading on these websites as a hobby can grow into a lucrative business without the person realising their tax obligations. In 2005 nearly £4 billion worth of items were traded on eBay in the UK. eBay (UK) Limited estimates more than 68,000 people in the UK now use eBay sales to generate at least one quarter of their income. Adult entertainment websites also pose a greater risk because of traditionally lower levels of compliance in the industry.

2.2 To encourage compliance, the Department provides information on its website and in printed guidance on the requirements for businesses in general to register for taxes. The two main e-marketplace sites in the UK, eBay and Amazon, also include details on their websites of the requirements to register for VAT and how this can be done. eBay are also working with the Department to develop further guidance for online traders in relation to their tax obligations. But 13 smaller e-marketplaces in the UK, whose websites we examined, do not.

2.3 The Department operates 32 Shadow Economy Teams[7], totalling some 276 staff across the country, whose role is to detect businesses which should be registered for VAT and other taxes. One of these, the Salford team, co-ordinated the investigation of all e-commerce cases between April 2002 and October 2005. Since then all teams have been responsible for managing their cases using guidance from the Salford team.

2.4 The Department has estimated that between 125,000 and 180,000 businesses which should be VAT registered are not. Each year it has detected around 5,000 businesses which have failed to do so. From April 2002 to the end of October 2005 the Shadow Economy Teams detected 76 e-commerce cases or around 30 cases a year, involving an average of almost £10,600[8] in VAT compared with almost £16,800 for all cases detected by the Department. This difference is because turnover of e-commerce businesses detected was much lower than that of other businesses. In common with other types of businesses detected by the Department, e-commerce businesses are also required to register to pay VAT in the future. The Department is currently running a trial which is checking whether these e-commerce businesses are submitting their VAT returns on time and the amount of VAT stated on their returns is reasonable. It is also checking that these businesses do not seek to deregister without a valid reason. At the end of the trial the Department will consider whether to extend these arrangements to other parts of the Department.

7 22 of these teams are Joint Shadow Economy teams and contain individuals from both HM Revenue and Customs and Department for Work and Pensions. The teams cover benefit/employment fraud as well as a range of direct and indirect taxes. Salford is a joint team.

8 The average VAT yield includes the net VAT liability (the net amount of tax arrears assessed as payable by the Department including penalties as a result of the checks) and the future revenue benefit (the estimated amount that will accrue to the Department over the following 12 months).

2.5 As part of the investigation work, the Department is seeking to estimate the overall level of internet trading by businesses operating on auction sites but so far has been unable to do so. It has also been unable to draw firm conclusions on their compliance with VAT requirements although the results suggest that over 60 per cent of the e-commerce businesses examined were registered or did not need to register for VAT. In the remaining cases the businesses needed to be registered or the Department could not determine the position because of insufficient information or are still investigating the cases. The Department also found that 16 per cent of the e-commerce businesses examined were non-compliant in filing VAT returns on time, paying on time and/or in calculating the correct amount of VAT which compares with over 30 per cent for all small and medium enterprises. In the course of the work the Department has analysed the characteristics of those businesses which are non-compliant or have failed to register to help with targeting future detection. The Department is planning to extend its research work to cover the risks to direct taxes, such as income tax, from e-commerce activities.

2.6 One constraint in pursuing investigations is when the Department cannot or finds it difficult to, identify the legal owner of a business which it wishes to investigate further **(Figure 5)**. It has 109 cases of businesses operating on e-marketplaces where it needs this information but does not have sufficient evidence for a court order to obtain it **(Figure 6)**. In some other countries such as Sweden and Australia, the tax authority has greater powers to obtain from e-marketplaces registered in those countries data on

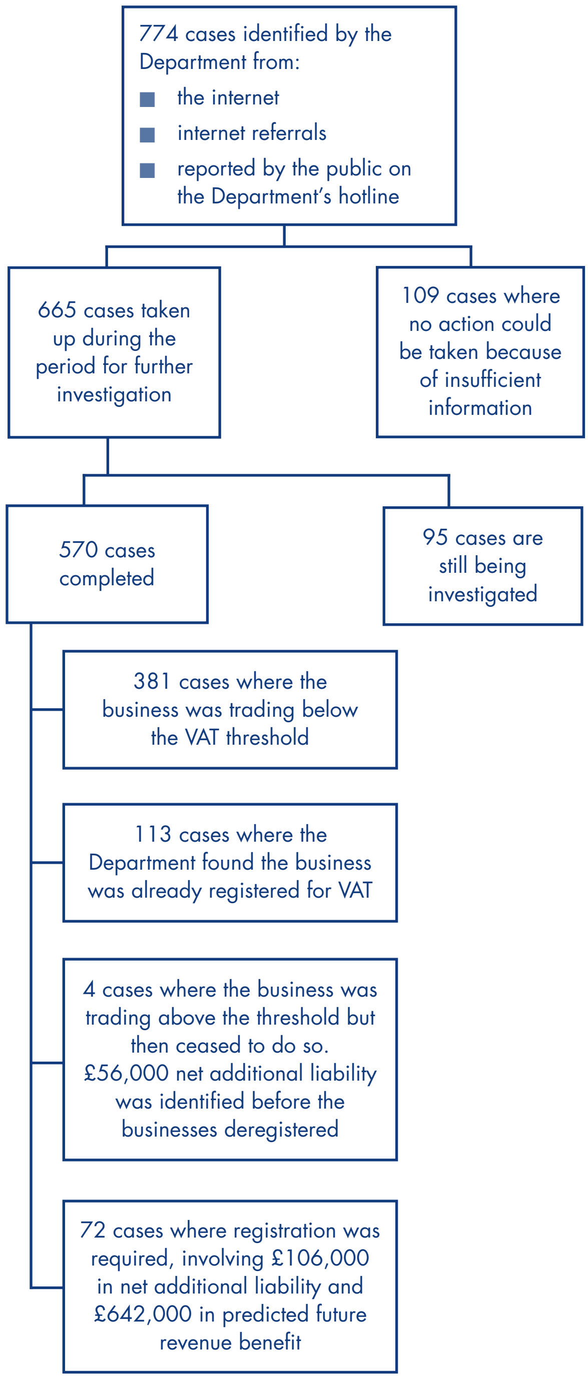
5 Case example illustrating the difficulties of tracing e-commerce businesses suspected of evading VAT

The Department found that an individual trading on an e-marketplace had sold jewellery valued over £50,000 over a two month period indicating that he may have traded above the VAT threshold. The individual also advertised on the website that his selling prices did not include VAT. The Department sent an email to the person listed in the contact details on the website but received no response.

Shortly afterwards the individual changed their user ID on the e-marketplace which the Department traced but received no response to further emails. The Department traced the address where the individual lived. After the individual registered voluntarily for VAT the Department established that he had been trading earlier than stated on the registration form. It collected over £18,000 in arrears of VAT including a penalty and assessed the future revenue benefit at over £15,000.

Source: HM Revenue and Customs

6 The results of e-commerce cases investigated between April 2002 and November 2005



Source: National Audit Office

NOTE

Within the 72 cases where registration was required 52 referrals were also made to other teams within the Department to investigate other possible compliance issues. 11 cases were referred to Department for Work and Pensions involving suspected fraud totalling £74,000.

all businesses and individuals trading on their websites. This information is then compared with taxpayer databases to identify those which have failed to register **(Figure 7)**.

2.7 The Department and other tax authorities such as Canada Revenue Agency, have also on occasion found it difficult to identify the owners of websites that are offering goods and services. The Department uses information, which is publicly available on www.checkdomain.com, one of several domain name registrars, to trace the owners. But in some cases only an accommodation address is provided or the details of the company that created the website, but not the website owner's details. Organisations such as Internet Corporation for Assigned Names and Numbers (ICANN) (an internationally organised, non-profit corporation based in the USA responsible for managing aspects of the internet) and the Organisation for Economic Co-operation and Development are examining how the quality of information held by domain registrars could be improved.

7 Other countries' approach to detecting businesses operating on auction sites which should be registered to pay taxes

In Sweden the Tax Agency is comparing third party data with the Agency's data on registered taxpayers to identify businesses which should be registered but are not. To do this the Agency obtains data in bulk from Swedish e-marketplace sites on the amount of sales by individuals and their contact details, and from payment service providers such as credit and debit card companies on transactions. In Sweden the main e-marketplace sites are registered in that country.

In Australia, the Tax Office served a legal notice on the Australian registered eBay marketing subsidiary requiring it to provide a list of sellers located in Australia that were trading above a particular threshold through the eBay.com.au website during the financial year 2002-03. Certain types of information relevant to Australian account holders and traders was received. The Tax Office then approached certain sellers directly as it considered appropriate.

Source: National Audit Office

2.8 The Department has had to invest considerable time and effort in applying its traditional detection and investigation techniques in e-commerce cases. It found that over half the businesses it investigated were already registered or were trading below the VAT threshold. To help improve the situation the Department has been testing various automated computer tools. One of these has been developed in conjunction with the Netherlands Tax Authority and has been incorporated into Web Robot, an advanced search engine that helps the Department to produce information on areas of internet activity and identify businesses which may need to register for VAT. In the cases identified the Department's staff contact the company owners for further information on their turnover and where necessary visit their premises to conduct a more in-depth check on their records. The Department also intends to use Web Robot in other areas of its work. It has committed £250,000 to developing Web Robot which became fully operational at the end of March 2006. In developing a business case for investing in Web Robot the Department estimated that the project would lead to at least 20 additional businesses registering each year. The Department also estimated that it will collect around an additional £1 million a year in revenue from using Web Robot. A number of overseas tax authorities have expressed interest in using Web Robot.

PART THREE

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

3.1 The internet has led to increased sales of goods by businesses outside the EU to customers in the EU. Around 45 million commercial consignments are imported by post into the UK each year from countries outside the EU including the Channel Islands. The recipients would normally pay import VAT and customs duty. However European Community legislation allows Member States to exempt from import VAT commercial consignments valued below £18[9]. Customs duty is also not payable if the duty due is less than £7 or the item is from the Channel Islands. The purpose of the European Community reliefs on import VAT is to reduce the costs that would be involved in collecting small amounts of VAT of up to £3.15 on goods costing £18. Some overseas suppliers legally split customers' orders to ensure the value of each consignment falls below the £18 threshold. In 2005 the Department estimated that the reliefs resulted in VAT foregone of £85 million a year, which could increase to £200 million in a few years[10].

3.2 One effect of the £18 relief is that the prices of certain imported goods are very competitive compared to those in the UK high street. Some seven per cent of purchases by customers in the UK of CDs, DVDs, vitamins and computer consumables and two per cent of UK purchases of lingerie and hosiery are from overseas businesses. Around half of sales by value to UK customers are from the Channel Islands. The relief is available on goods supplied from the Channel Islands because they have a special relationship with the EU. Under an agreement the Channel Islands are part of the customs territory of the EU and goods are traded freely between the Islands and the EU. There has been longstanding trade of this nature between the Channel Islands and the UK. But the growth in e-commerce has led some UK-based suppliers to set up business operations in the Channel Islands to sell goods to UK customers to take advantage of the relief.

3.3 The States of Jersey Government has been concerned that the way some of these UK-based companies operate their business activities could undermine the Island's good international reputation and integrity. In February 2006 the States of Jersey Government noted that some UK-based companies operating in the DVD/CD market should have applied for licences but have not. All such companies were then required to apply for a licence to trade. Those companies that had been trading in a manner outwith the new policy were granted non-renewable, time limited licences by the States of Jersey to allow them gradually to reduce and eventually discontinue their activities.[11]

9 Non-commercial consignments valued up to £36 such as gifts are also exempt from import VAT.

10 The Department's estimate is based on data in the Office for National Statistics General Household Expenditure survey for 2003 uprated to 2004-05 prices for six categories of products (CDs, DVDs etc and unexposed film; vitamins; contact lenses; lingerie; hosiery and other computer consumables) from which the Department has calculated the estimated VAT receipts. The Department has used industry estimates on the market share taken by imports valued under the £18 relief to then calculate the amount of VAT foregone in 2005. It has assumed that imports will account for 15 per cent of the UK market for these products in a few years time.

11 Policy for the Fulfilment Industry – States of Jersey Government – February 2006.

3.4 The Department accepts that the VAT reliefs may be claimed on this trade, providing the goods are supplied by a business established outside the EU, and imported by a private person, or a business that is unconnected with the supplier. In Budget 2006 the Government announced that it is keeping under close review the way in which some UK businesses have restructured their activities to exploit the VAT-relief that applies to commercial consignments imported from outside the EU and will consider options for changing the relief if it continues.

3.5 The British Association of Record Dealers notes that small businesses selling certain types of goods such as CDs and DVDs in the high street have lost business as a result of increased competition from Channel Island based retailers who can charge lower prices. In February 2006, the House of Commons All-Party Parliamentary Small Shops Group published High Street Britain: 2015[12] in which it recommended amongst other things that the Government should reduce the reliefs to the minimum allowed under EU legislation of €10 or around £7, which they believe would eliminate most of the trade from outside the EU to the UK. The UK currently applies the maximum relief allowed. Denmark has obtained a derogation removing the relief on magazines printed in the EU but imported from surrounding islands and Norway **(Figure 8)**.

3.6 Because import VAT is payable on goods above £18, some overseas suppliers advertise that they will describe items incorrectly or underdeclare the value of goods to help their customers evade tax. Under international postal agreements, the sender must complete a Customs declaration. The declaration includes a brief description of the goods, their value and whether they are gifts or commercial items. The Department provides information on its website www.hmrc.gov.uk to discourage UK customers from ordering goods from unscrupulous suppliers and to inform shoppers of the charges that apply, and the penalties for non-compliance with the rules. The maximum penalty for non-compliance is £2,500 although to date no penalties have been imposed mainly because the sender is outside the UK's jurisdiction and the addressee may not realise that the sender has misdeclared the items. In the past the Department has organised publicity campaigns on the internet including introducing links to the Department's website and "Pop-up" messages containing information for potential purchasers on their tax obligations for excise duties.

8 The derogation obtained by Denmark

Denmark currently provides relief from import VAT for imports of small consignments of a commercial nature from outside the EU. The Danish European Community reliefs limit is DKK80 (€10). The Danish Tax Authority found that some Danish publishing companies were re-routing the distribution of certain magazines and periodicals via a third country. Random checks showed that many consignments were printed in the EU, exported at a zero-rate of VAT to a country outside the EU (mostly the Åland islands[1] and Norway) and from there sent to subscribers in Denmark free of import VAT, as each consignment was valued below Denmark's European Community Relief limit.

The Danish Tax Authority's investigations in the first nine months of 2003 found that some 3.5 million magazines and periodicals were imported from the Åland islands, with an estimated loss of revenue of some DKK47 million, or around £4.5 million. The Danish government obtained a derogation from the European Commission to remove the relief on magazines and its VAT law was changed accordingly from 1 June 2005.

The Danish Tax Authority is seeking a change in the EU rules to abolish the relief and introduce a new and simple VAT-collection system for small consignments, or if that is not possible a change of the EU rules allowing Member States to exclude certain goods such as magazines from the European Community relief for small consignments.

Source: National Audit Office

NOTE

1 Åland is an autonomous, Swedish-speaking region of Finland.

12 The All-Party Parliamentary Group was set up by a cross party group of MPs to raise awareness among Parliamentarians of a broad range of issues of concern to small shopkeepers. The report – High Street: 2015 – provides the analysis of evidence, both written and oral, submitted to the Inquiry by the Parliamentary Group on the long term prospects of the UK's small retail sector.

3.7 Import VAT is due on packages shipped from countries outside the EU at the point they enter the UK. This means that special arrangements are needed for its collection as the Department's normal checks on businesses will not cover the import VAT due on these packages. The Department works with Royal Mail, Parcelforce and express carriers to ensure VAT is paid on imports of commercial consignments valued over £18 and non-commercial consignments valued over £36. Royal Mail Group pays to the Department around £20 million a year in import VAT and other taxes on some 900,000 chargeable small packages, and collects this from addressees. The Department has staff permanently based at the Royal Mail sorting centre at Mount Pleasant and the Parcelforce depot at Coventry to undertake checks to detect and seize prohibited items such as firearms and drugs. They also check selected small packages to ensure that the correct amount of VAT and customs duty is paid. The Department does not collect data on the number of packages examined or additional amounts of VAT collected.

3.8 Express carriers also bring small packages into the country although most of their business is delivering commercial consignments from one business to another. In 2004-05 these carriers submitted around 3.5 million declarations paying the Department approximately £650 million in import VAT and customs duty. Express carriers normally use the Department's Customs Freight Simplified Procedures to declare the consignments to the Department using a simplified electronic process. Under this procedure the Department selects consignments for examination before allowing them to be removed to inland premises for clearance and release. The Department carries out post-clearance audit checks to confirm the procedure is being operated satisfactorily. It can exclude businesses from using the Simplified Procedures where its checks produce unsatisfactory results. To date the results have been satisfactory.

3.9 The Department also has longstanding arrangements known as the Import VAT Accounting Scheme with the Customs and Postal authorities in the Channel Islands. This enables businesses based there to charge, collect and pay import VAT to the Department on commercial consignments with a value between £18 and £2,000 that would normally be payable on importation of the goods into the UK. In 2004-05 Postal authorities in the Channel Islands paid over £10.3 million in import VAT to the Department. Arising from the increase in the number of goods ordered over the internet, the Department introduced revised Memoranda of Understanding for the States of Jersey in January 2005 and The States of Guernsey in August 2005 requiring the Customs and Postal authorities to follow certain procedures for authorising businesses to use the arrangements; examining consignments and auditing businesses including ensuring they pay the correct amount of import VAT. The Department has recently set up similar arrangements with Hong Kong Post in February 2005 for certain types of goods valued between £18 and £100 and is looking to extend this to other countries such as Singapore, Australia and New Zealand.

PART FOUR

Tackling the risks to VAT from supplies of e-services

VAT on e-services supplied by businesses from outside the EU to customers in the EU

4.1 When the EU VAT rules governing the supply of services were first introduced patterns of trade were such that services were usually supplied by businesses to customers within the same country. VAT was collected by the tax authority in the EU country where the supplying business was located. VAT was not payable on e-services supplied from outside the EU to non-business customers located in countries in the EU **(Figure 9 overleaf)**.

4.2 The nature of e-services means that businesses do not need to be located near their markets leading to an increase in the supply of e-services from businesses outside the EU to customers in the EU. Because the VAT place of supply rules meant that VAT was not payable on these e-services these suppliers had a competitive advantage over those within the EU. The European Commission and EU Member States became increasingly concerned about the effects on competition. To address this, an EC Directive introduced temporary changes to the place of supply rules for three years from July 2003 requiring non-EU based businesses to charge VAT on supplies to EU customers and register for and pay VAT in every Member State where they have customers. The change also meant that EU businesses no longer had to charge VAT on supplies made to non-EU customers, although they are still required to charge and pay VAT in the Member State where they are located regardless of where their EU customers reside (Figure 9 overleaf).

4.3 The practical effect of these arrangements is shown in **Figure 10 overleaf**.

4.4 To reduce the costs to businesses of complying with the revised rules, an electronic system called the VAT on e-Services System (VoeS) was introduced. VoeS allows a non-EU business providing e-services to customers in the EU to register for the scheme with one EU Member State of their choice and account for VAT electronically in all Member States where it makes supplies. Businesses make a single payment which is distributed via a clearing system for Member States to pay over the VAT they receive on behalf of other Member States. Information about the VAT rates applicable in each Member State is available on the European Community website.

4.5 EU Member States have no legal status to enforce their tax regimes in non-EU countries without special arrangements with those countries. Within the EU there are arrangements to ensure that a business based in one Member State complies with their VAT obligations in another EU Member State. The change in the rules and the introduction of VoeS means that the UK and other Member States are now receiving payments of VAT on services that were previously supplied VAT free.

9 The rates of VAT in force on e-services before July 2003, after July 2003 and under the Commission's 2005 proposals

Customer based in	Business based in: UK	EU Member State A	Non-EU country
UK			
Before July 2003	VAT rate in UK	VAT rate in Member State A	Outside scope of EU and UK VAT
From 1 July 2003	VAT rate in UK	VAT rate in Member State A	VAT rate in UK
Under 2005 proposals	VAT rate in UK	VAT rate in UK	VAT rate in UK
EU Member State B			
Before July 2003	VAT rate in UK	VAT rate in Member State A	Outside scope of EU and UK VAT
From 1 July 2003	VAT rate in UK	VAT rate in Member State A	VAT rate in Member State B
Under 2005 proposals	VAT rate in Member State B	VAT rate in Member State B	VAT rate in Member State B
Non-EU country			
Before July 2003	VAT rate in UK	VAT rate in Member State A	Outside scope of EU and UK VAT
From 1 July 2003	Outside scope of EU and UK VAT	Outside scope of EU and UK VAT	Outside scope of EU and UK VAT
Under 2005 proposals	Outside scope of EU and UK VAT	Outside scope of EU and UK VAT	Outside scope of EU and UK VAT

Source: National Audit Office

10 Example showing the practical application of the changes made to the place of supply rules for e-services in July 2003

For supplies of e-services to non-business customers within the EU, VAT is due in the EU Member State where the business is based. For supplies from a non-EU country, VAT is due in the EU Member State where the customer resides.

- A UK customer downloads a video clip from a business based in the UK. VAT is due at 17.5% in the UK
- A UK customer downloads a video clip from a business based in Italy. VAT is due at 20% in Italy[1]
- A UK customer downloads a video clip from a business based in Japan. VAT is due at 17.5% in the UK
- An Italian customer downloads a video clip from a business based in Japan. VAT is due at 20% in Italy
- A Japanese customer downloads a video clip from a business based in the UK. No VAT is payable in the UK or EU.

Source: National Audit Office

NOTE

1 If European Commission proposals are accepted UK VAT will be charged.

4.6 In December 2005 900 businesses were registered under VoeS in the EU, of which 202 were in the UK. From July 2003 to December 2005, the Department has received £59 million in total from businesses registered under VoeS. Some £28 million was collected from businesses registered under VoeS in the UK, £13 million of which it has paid over to other Member States. The Department has received £44 million from eight other Member States. The Department estimates that around 80 per cent of the value of electronically supplied services by non-EU businesses to EU-based customers is being declared. This estimate is based on an analysis of market share of businesses registered under VoeS and the Department's checks on whether those large businesses it would expect to register under the scheme have done so.

4.7 A Member State can audit the records of businesses that are registered under VoeS to ensure they are complying with their VAT obligations. As at February 2006 the UK had not completed any such audits but four are currently underway. In addition, steps need to be taken to identify and estimate the liability of those non-EU businesses supplying e-services to EU customers that should be registered in a Member State to pay VAT, but are not. To do this EU Member States need to have administrative arrangements in place for co-operation on VAT including information exchange with the non-EU countries in which the businesses are based. Currently the UK does not have any VAT administrative co-operation agreements with non-EU countries, but the Government announced in Budget 2006 that it will propose legislative changes to make such arrangements possible. The UK currently has over 100 bilateral agreements in the area of direct taxation and, where appropriate, it will seek to extend the exchange of information provisions in these agreements to cover all taxes including VAT. In addition, the UK is considering ratifying the joint OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters which provides a legal basis for the exchange of information on taxpayers between countries on a multi-lateral basis. Twelve countries, including the USA, have already signed-up to the Convention and ratification would quickly increase the UK's ability to co-operate and exchange VAT information with several other jurisdictions.

VAT on e-services supplied within the EU

4.8 Currently businesses based in the EU supplying e-services within the EU are required to charge and pay VAT in the Member State where they are based. Thus, UK businesses supplying e-services pay VAT in the UK and are subject to the Department's normal checks on businesses. The nature of e-services is such that services can be provided from a distance and costs including the rate of tax can influence where they locate. Following the change in rules in July 2003 a number of businesses based outside the EU set up operations within the EU. A number of these businesses chose to locate in countries with the lowest rates of VAT. They are now required to pay VAT in the Member State where they are located.

4.9 A number of EU-based businesses also relocated to other Member States with lower VAT rates to compete more effectively in supplying e-services to EU customers. Some have relocated from the UK to Luxembourg or Madeira, where VAT is charged at 15 per cent compared to the 17.5 per cent they were paying. The Department estimates that up to £450 million a year in VAT would potentially be collected if all supplies of e-services to UK customers were liable to VAT in the UK. This is therefore the maximum amount of VAT at risk if all suppliers were to make supplies to UK customers from elsewhere in the EU.

4.10 In 2005 with the support of the UK Presidency, the European Commission put forward a further proposal which would change the place of taxation for services in certain cases from the country where the supplier is based to the country where the customer is based. If adopted this would require a business supplying e-services to charge and pay VAT in every Member State where it has customers (Figure 9). The temporary rules introduced in July 2003 would be subsumed within these changes.

4.11 The European Commission recognises that the changes would lead to additional burdens on businesses and consulted with them on the proposals. It concluded that the burdens on all businesses involved in cross-border trade within the EU would be reduced by introducing a VAT "One-Stop-Shop" Scheme. This is because:

- The scheme would enable businesses to meet their EU-wide compliance obligations using a single VAT number throughout the EU and declaring their VAT liability in different Member States using a web-based form accessed via the business' own tax authorities' website;
- Guidance would be available through the website on the rules applicable in other Member States;
- There would be uniform data requirements and consistent reporting formalities across the EU; and
- The business' own tax authority would take the lead on any VAT audits.

Businesses have also previously suggested that they should be able to make one payment to the tax authority in the Member State where it is registered, which would then redistribute to other Member States the VAT due to them.

4.12 Under the proposed changes businesses are concerned about the difficulties of identifying where their customers are located so that they can charge the correct rate of VAT on e-services and pay it over to the right Member State. The OECD has suggested a number of ways this can be done including looking at card details and invoice addresses within payment information, using tracking software to determine customer location, looking at the nature of the supply to determine who it is made to and what components it consists of and looking at digital certificates which provide a unique set of numbers for a business so its authenticity can be checked. The Department's guidance for businesses using VoeS closely mirrors the OECD's suggestions and could be used as guidance for EU businesses if a "One-Stop-Shop" were introduced **(Figure 11).**

4.13 The proposed "One-Stop-Shop" and changes to the VAT place of taxation rules are currently being discussed by Member States. Both were priorities for the UK Presidency from July to December 2005. The Commission has indicated that it will look at the relationship between the "One-Stop-Shop" and the VoeS scheme, in particular whether VoeS can be subsumed within it. The results are due to be published before 30 June 2006.

11 Extract from the Department's VAT Information sheet 05/03: Electronically supplied services: evidence of customer location and status

a Use your customer's postal address provided it has been used to send goods, catalogues, samples, CD ROMs, invoices, correspondence, etc. and the correspondence has not been returned; or

b Accept payment by credit/debit card and compare the customer's home address with the billing address; or

c Accept payment by credit/debit card and, using proprietary software, compare the customer's country of residence with the location of the issuing bank; or

d Use geo-location or proprietary software to verify where the customer belongs but then rely on satisfactory alternative evidence if the match fails; or

e Use systems that are configured to identify where the service is used and enjoyed (e.g. telecommunication suppliers). The Department will accept the arrangement as a proxy for identifying the country where the customer belongs.

Source: HM Revenue and Customs