National Audit Office

HM REVENUE & CUSTOMS

VAT on e-commerce

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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.