EU proposal on more flexible VAT rates

On 18 January 2018, the European Commission published a legislative proposal to allow Member States more flexibility when defining their national reduced or zero VAT rates. These changes’ entry into force is planned for 2022, in connection with the implementation of the definitive VAT regime for B2B cross-border supplies (previous coverage in VAT alert of 5 October 2017).

Current legislation

The European VAT Directive contains an annex (Annex III) listing the products and services that can benefit from a reduced rate (i.e. not lower than 5%). In principle, Member States can only apply reduced VAT rates to products and services covered in this list. However, in addition to this list, a series of individual derogations and stand still measures exist, allowing Member States to apply rates below 5% or even zero rates on specific products.

EU Commission Proposal

Given the trend to increasingly apply VAT in the Member State of consumption (so-called ‘destination principle’), the European Commission announced in its 2016 VAT Action Plan that it would grant Member States more flexibility in setting VAT rates. Under a destination principle, VAT rate shopping is very much excluded given the VAT rate is not influenced by the supplier’s country.
The current proposal mainly provides for two important changes:

- Member States would be allowed to introduce an extra reduced rate between five and zero percent, next to the two currently allowed reduced rates of a minimum of five percent. Member States would also be able to set zero rates for specific products.

- Member States themselves could define the products and services subject to a reduced or zero rate, whereby EU law would only provide for a limitative (short) list of goods or services that would be excluded from reduced rates. The current proposal lists excise products such as oil and gas, alcohol and tobacco, but also financial services, as well as computers and electronic products. The European VAT Directive’s current Annex III would be replaced by such a negative list of products to which reduced or zero rate cannot be applied by Member States.

To maintain a degree of rate harmonisation, under the new rules, Member States would be required to ensure that the reduced rates "are for the benefit of the final consumer and that the setting of these rates pursue an objective of general interest". Moreover, they will need to ensure that the weighted average VAT rate on a country basis exceeds 12%, taking into account all VAT rates in force. This provision should tackle Member States’ aggressive policies in order to attract cross-border purchases.

**Timeline**

The entry into force of the new provisions on VAT rates has been linked to the introduction of the definitive VAT regime, which is intended for 2022. However, this will still need to be confirmed in the detailed proposals for that regime, which are expected in the course of 2018.

This link is rather surprising. The destination-principle is, to a large extent, already realised for cross border services, and will be achieved for cross border B2C goods supplies through the recently approved e-commerce VAT changes, with effect from 1 January 2021.

Considering the much awaited modernisation of the reduced VAT rate product list (e.g. e-books), the delayed entry into force is somewhat disappointing. In its proposal however, the Commission also commits to conducting a review of Annex III before these new rules’ entry into force, to take account of specific requests by Member States. A legislative proposal by the Commission to adapt Annex III can therefore be expected in the next few months or even years.
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