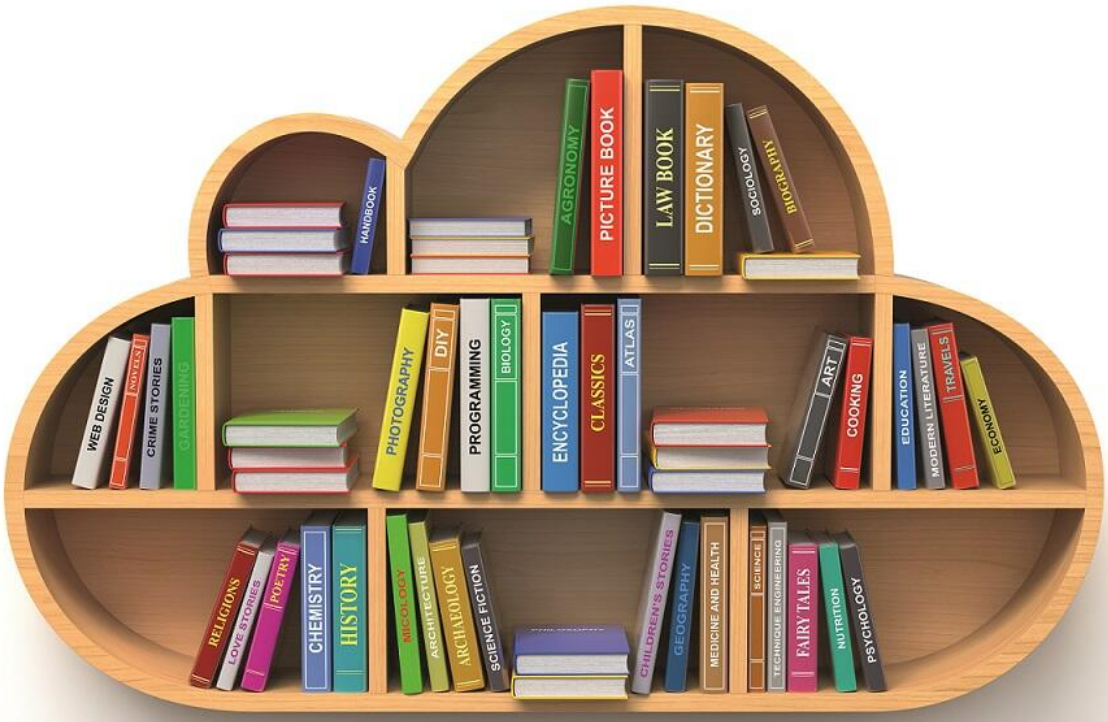
Where EU policies collide

Indirect Tax



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Anne Fairpo reviews the recent ECJ cases on the VAT treatment of electronic books

Key Points

What is the issue?

The concept of electronic books was still in the realm of science fiction when the UK introduced VAT in 1973. Back then, the UK was permitted to zero-rate some types of supply – one of them being information

What does it mean for me?

Electronic books are established as a service for VAT purposes. If you pay for an electronic book, access to it generally involves acceptance of a user licence agreement

What can I take away?

Electronic books aren't physical and so cannot be 'books' for the purposes of VAT – so a supply of an electronic book is standard-rated

When the UK introduced VAT in 1973, it was permitted for some types of supply to be zero-rated if this was considered desirable for defined social purposes and to the benefit of the consumer.

One accepted purpose was the supply of information – particularly through books, newspapers and periodicals. The UK has continued to zero-rate information produced in physical form. But over the past 10 years or so information has become increasingly incorporeal and so the question of VAT treatment has been tested – and not just in the UK; many other European countries have a lower (not always zero) rate of VAT for books.

Reduced VAT rates – when are they permitted?

In 1991, the EU agreed to harmonise VAT rates to an extent. This agreement set a minimum VAT rate of 5% , but allowed countries to continue charging lower rates, including zero rates, that were in place on 1 January 1991 – and permitted by EU law – for a 'transitional period' (Directive 2006/112/EC, Arts 98 and 110). There is no specific date when this period will end: it will be whenever 'definitive arrangements' are agreed by member states (Directive 2006/112/EC, Art 402). No new types of supply can be brought within the zero rate, however.

Member states are allowed to apply one or two reduced rates of VAT, but only to specific categories of goods and services (Directive 2006/112/EC, Annex 3) – this

includes the supply of ‘books on all physical means of support’.

VAT treatment of electronic books – why the problem?

The concept of electronic books was still – in practical terms – in the realm of science fiction when the UK introduced VAT. Even *The Hitchhiker’s Guide to the Galaxy* by Douglas Adams was five years away.

As a result, it’s not startling that the question of how to treat an electronic, downloadable, book did not feature in VAT rate considerations in 1973.

The first main consideration of how to deal with electronic books comes in the Annex to the VAT on E-Commerce Directive (2002/38/EC), published in 2002, which includes ‘the digitised content of books and other electronic publications’ as an example service at Item 3 (B) of the table of electronically supplied services. This treatment predates the first mainstream electronic book reader, the Sony Librie, introduced in 2004. Perhaps a different treatment might have been envisaged if the member states had been playing catch-up on electronic books. The VAT on E-Commerce Directive was, however, concerned only with the place-of-supply rules, not how the VAT rate for the service should be determined.

So, electronic books are established as a service for VAT purposes. Arguably, that makes sense from a legal perspective. If you pay for an electronic book, the access to it generally involves acceptance of a user licence agreement. That agreement will often include substantial restrictions. You can’t give away an electronic book since access may be restricted to a single device. Some electronic books depend on an online service to authenticate access – if that service stops, access is blocked.

Buying access to an electronic book is similar to entering into a rental agreement – buying a service. Ultimately, the publisher can remove access, as Amazon did in July 2009 when it deleted George Orwell’s *Nineteen Eighty-Four* from purchasers’ accounts and electronic book readers. Of all the texts that this power could have been demonstrated on … you couldn’t make it up. The file was removed because it was apparently an unauthorised edition and Amazon did credit purchasers’ accounts, but it still demonstrates the point – electronic books are usually something that the purchaser has access to, not something that the purchaser owns. Some publishers do not restrict rights in that way for electronic books that they sell directly, but they are relatively uncommon.

Given, then, that electronic books are a service for VAT purposes, and not a supply of information, that's where the VAT issue kicks in.

A supply of goods or services is subject to VAT at the standard rate unless a reduced rate applies to the supply, or the supply is treated as exempt (VATA 1994 s 2). Zero-rating is permitted by VATA 1994 s 30, but applies only to supplies within Sch 8 – and Grp 3 of Sch 8 covers books.

'Book' isn't defined in statute, so the term has to take its ordinary meaning. The ordinary meaning of 'book' for VAT purposes in the UK was established in *C & E Commrs v Colour Offset Ltd* [1995] STC 85 – where May J held that the term 'always refers to an object whose necessary minimum characteristics are that it has a significant number of leaves, now usually of paper, held together front and back by covers usually more substantial than the leaves'. This was in 1995, and the courts do acknowledge that 'when a word is given its ordinary meaning, that meaning may change over time in accordance with common usage and understanding' (*Magic Memories Group (UK) Limited v HMRC* [2013] UKFTT 730) – so perhaps the ordinary meaning of 'book' might come to include an electronic book, but that hasn't happened yet.

The European Court of Justice (ECJ) had, until recently, similarly left open the question of whether things might change. In September 2014, in *K Oy* (Case C-219/13), it held: 'It is for the referring court to ascertain … whether books published in paper form and books published on other physical supports are goods which are liable to be regarded by the average consumer as similar.' However, the recent cases against Luxembourg and France have made it clear that the ECJ isn't about to equate electronic books and physical books.

So far, electronic books aren't physical and so cannot be 'books' for the purposes of VAT – so a supply of an electronic book is a standard-rated supply because it is not a supply that is within the reduced rate rules or exempt from VAT. As noted, the zero rate in the UK cannot be extended to supplies that were not zero-rated in January 1991.

Fiscal neutrality

In general, the EU isn't in favour of differing rates for similar transactions: '[T]he common system of VAT should, even if rates and exemptions are not fully

harmonised, result in neutrality in competition, such that within the territory of each member state similar goods and services bear the same tax burden, whatever the length of the production and distribution chain.' So says paragraph 7 of the preamble to Directive 2006/112/EC (the main VAT Directive).

This is 'fiscal neutrality', derived from one of the main principles of VAT within the EU, and is intended to ensure that – as set out in the preamble – VAT should have the same impact on substantially similar transactions. The principle from which it is derived is that of the European single market, and the prevention of the proper working of a free market. Without fiscal neutrality, one transaction could have a higher burden of VAT in comparison with a functionally similar transaction. This would distort competition and harm the proper working of a free market in goods and services.

As a result, the ECJ will usually not permit actions that create a difference between functionally similar transactions – regardless of national law – unless the Directive creates the difference itself. In this case, the ECJ will usually attempt to narrow the range of transactions affected. For example, the Directive creates exemptions from VAT for some financial services; similar services are not exempt, and the ECJ in this instance would interpret the law narrowly to ensure that the exemption applies only to transactions that are clearly within the scope. Functional similarity is not enough to extend exemption. Whether this is useful depends on a business's VAT recovery position.

For books and electronic books, the ECJ has been reluctant to specifically apply fiscal neutrality to such transactions, as noted in K Oy. Having in effect referred that decision back to the national courts, in March the ECJ also considered the cases of *European Commission v Luxembourg* (Case C-502/13) and *European Commission v France* (Case C-479/13). Both countries had introduced reduced rates for electronic books – 3% in Luxembourg, 5.5% in France – and, this time, the court took a strict and narrow interpretation of the legislation by following the principle set out above.

Luxembourg had decided that the term 'book' should be broadly interpreted so that sales of electronic books came within their existing 3% rate for books (a reduced rate permitted, as with the UK's zero rate, by the transitional provisions of the VAT Directive). France had specifically introduced a statutory provision equating electronic books with physical books, which were also within an existing reduced rate. It was, in the case of France in particular, argued that electronic books fell

within the scope of the supplies permitted to be subject to VAT at a reduced rate (in Annex 3, as above), on the basis that some physical support is needed to read an electronic book such as a computer, phone or electronic book reader.

The ECJ decided that, as the physical support required was not included in the sale of an electronic book, Annex 3 does not cover electronic books and that '[t]he principle of fiscal neutrality cannot extend the scope of reduced rates of VAT to the supply of electronic books'. The support for this was stated by the ECJ to be the Zimmerman case (Case C-174/11), which found that fiscal neutrality 'is not a rule of primary law against which it is possible to test the validity of an exemption provided for [by the Directive]'.

The digital single market – the future?

In December 2011, the EU issued a communication on the future of VAT, which stated: 'The issue of equal treatment for products which are available in both traditional and online formats provoked considerable reactions in the public consultation. Those issues need to be addressed.'

In May this year, the EU issued a communication on a digital single market strategy: this includes a proposal to take legislative steps to modernise and simplify consumer rules for online and digital purchases. The communication envisages a digital single market 'where individuals and businesses can seamlessly access and exercise online activities under conditions of fair competition'.

This is, of course, in line with long-standing EU principles such as fiscal neutrality, but glosses over some of the problems that arise with VAT and with the issue of electronic books in particular. The 'issues [that] need to be addressed' in 2011 remain open and – given the recent decisions of the ECJ – may need to be addressed by the EU in some statutory form.