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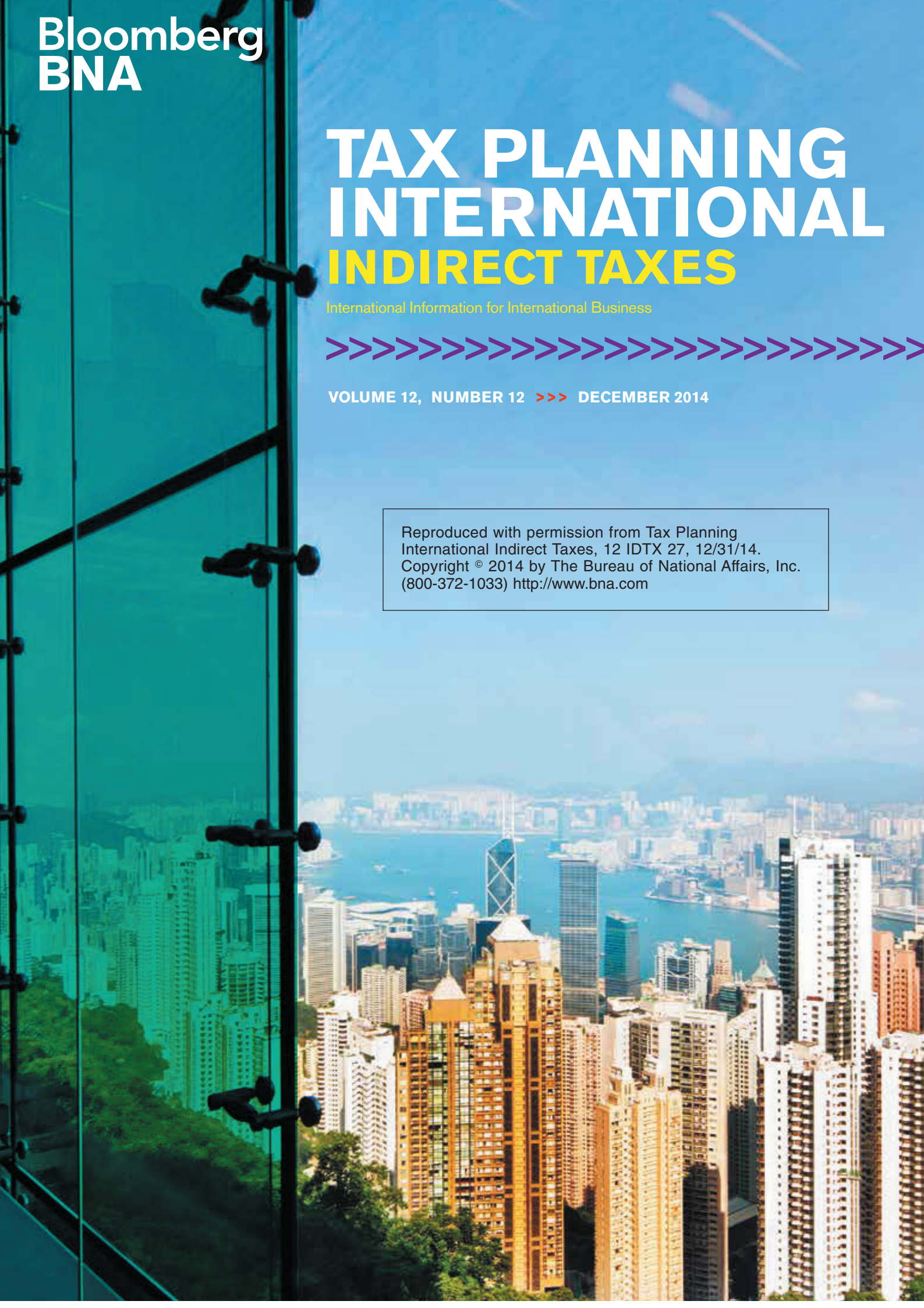

Viewpoint: VAT and Distortions of Competition in the Digital Age

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The third article in our new Viewpoint series examines the difficulties arising from granting different VAT rates for similar goods and services.

K Oy

In its widely misreported judgment in Case C-219/13 *K Oy* (September 11, 2014), the Court of Justice of the European Union (CJEU) took steps towards addressing an issue which is currently exercising the EU publishing industry: the discrepant tax treatment of paper books and books in other formats. The case was referred from Finland, where sales of books in paper format are subject to a reduced rate of VAT, whereas audiobooks and books on a CD or USB stick are subject to the standard VAT rate: currently a hefty 24%.

Article 98 of the Principal VAT Directive permits member states to apply reduced rates of VAT to goods or services specified in Annex III, including "books on all physical means of support". Thus member states have the discretion whether to apply the reduced rates. However, their discretion is not absolute. They must exercise it in accordance with the principle of fiscal neutrality, which precludes similar goods or services which are in competition with each other, being treated differently for VAT purposes.

The question therefore arose, of whether a member state which chooses to subject the supply of books on printed paper to a reduced rate of VAT is thereby compelled to extend the application of the reduced rate to supplies of books on all physical supports other than paper. The Court's answer was, in essence, that it depends on whether in the member state in question, books which are published in paper form and books which are published on other physical supports are liable to be regarded by the average consumer as similar.

The judgment is interesting in two respects.

First, the Court did not really grapple with the difficulty of how national courts are to go about the task of determining whether different types of goods are similar in the eyes of the average consumer. It merely elaborated the test in a variety of formulations, such as "whether or not the differences between them have a significant or tangible influence on the average consumer's decision to choose one or other". This is a broader problem which bedevils the application of fiscal neutrality in the sphere of VAT. The principle of fiscal neutrality has an important objective (avoiding distortion of competition) and a seemingly simple test at its heart (are the goods similar from the perspective of the average consumer?) but its practical application can prove highly problematic for national courts. Since the comparison is between products which are similar but not identical, there will necessarily be differences between the product groups, such as the differences between butter and margarine, between wine and beer, between Pepsi and Coke. How is the national court to go about determining whether the differences are "determinative" for the notional "average customer"?

The concept of whether two similar products are substitutable will be familiar to competition lawyers. In competition law, economic tools are deployed in order to arrive at an objective assessment of substitut-

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ability, in particular the SSNIP test (the test of a small but significant non-transitory increase in price). But in competition law, the focus is on the reaction of the marginal consumer, not the average consumer. So far, courts determining similarity of goods for VAT purposes have shown no inclination for using the economic tools which are prevalent in competition law. A rough and ready approach of focusing on the likely point of view of the notional "average consumer" has its advantages, not least avoiding the need for detailed economic expert evidence. However, it does risk rendering the application of the test in VAT impressionistic, subjective and legally uncertain.

Secondly, the judgment is interesting in respect of what the Court did not decide, despite widespread media coverage suggesting otherwise. The Court considered the difference in VAT treatment between paper books and books on other physical means of support (e.g. CD-ROM and USB stick). The judgment did not address an issue of far greater commercial significance in the application of VAT to publishing, namely the difference in VAT treatment between paper books and e-books. This is currently a highly contentious area. Article 98 of the Principal VAT Directive stipulates that the reduced rates shall not apply to electronically supplied services. The European Commission is firm that the provision of e-books is an electronically provided service, which has led many member states (such as the UK) to refuse to accede to calls for a reduced rate of VAT on e-books, on the basis that EU law prohibits such a move. Those member states that have introduced reduced rates for e-books (France and Luxembourg) are facing infraction proceedings. At the same time, the European Commission is currently working on proposals to address "the challenge of convergence between the online and the physical environment", a project it has been working on since 2011. It will be interesting to see whether the Commission's proposals are underpinned by any economic analysis. If the EU really is committed to ensuring that VAT does not give rise to distortions of competition, as the Commission claimed in its press release relating to the infraction proceedings, it needs to expedite tax parity between digitally delivered goods and their tangible substitutes.

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