VALUE-ADDED TAX IN EUROPEAN TAXATION SYSTEM AND HARMONIZATION OF VAT DURING THE INTEGRATION PROCESS OF TURKEY

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I hereby declare that all information in this document has been obtained and presented in accordance with academic rules and ethical conduct. I also declare that, as required by these rules and conduct, I have fully cited and referenced all material and results that are not original to this work.

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ABSTRACT

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This thesis analyzes the value added tax system (VAT) in the European Union (EU). Primarily, the issue of tax harmonization and legal basis of tax harmonization in the context of European Union is studied. Furthermore, this thesis makes a comparison of VAT legislation in the EU and Turkey and identifies differences between the EU VAT system and Turkish VAT Law. Lastly, within the framework of finding similarities between Turkish and EU VAT legislation, the thesis tries to examine whether major harmonization laws are needed to be adopted in the accession process in the field of VAT.

Keywords: tax harmonization, value added tax, European Union, Turkey

ÖZ

AVRUPA VERGİLENDİRME SİSTEMİNDE KATMA DEĞER VERGİSİ VE TÜRKİYE'NİN ENTEGRASYON SÜRECİNDE KATMA DEĞER VERGİSİ UYUMU

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Bu tez Avrupa Birliği'nin Katma Değer Vergisi (KDV) sistemini incelemektedir. Öncelikli olarak, Avrupa Birliği (AB) kapsamında vergi uyumlaştırması konusu ve vergi uyumlaştırmasının hukuki temelleri araştırılmaktadır. Ayrıca, Avrupa Birliği ve Türkiye KDV mevzuatları karşılaştırılmakta ve Avrupa Birliği KDV sistemi ve Türkiye KDV Kanunu arasındaki farklılıklar belirlenmektedir. Tez, nihai olarak, Türk KDV Mevzuatı ile Avrupa Birliğinin bu konudaki müktesebatının paralelliği çerçevesinde, üyelik sürecinde KDV için köklü uyum yasaları gerekip gerekmediği konusunu incelemeye çalışmaktadır.

Anahtar Kelimeler: vergi uyumlaştırması, katma değer vergisi, Avrupa Birliği, Türkiye

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LIST OF ABBREVIATIONS

BEPGs	Broad Economic Policy Guidelines
CCCTB	Common Consolidated Corporate Tax Base
ECOFIN	Economic and Financial Affairs Council
EEC	European Economic Community
EMU	Economic and Monetary Union
EU	European Union
EC	European Community
ECJ	European Court of Justice
GDP	Gross Domestic Product
GST	Goods and Services Tax
SEA	Single European Act
US	United States
VAT	Value Added Tax

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CHAPTER I
INTRODUCTION

European Union accession negotiations with Turkey were opened on October 3, 2005, with the adoption of the Negotiation Framework by the Council of the European Union. Accession negotiations are vital for monitoring and helping candidate countries to prepare themselves in order to fulfill the obligations of European Union membership.

After then the screening process, an analytical examination of the *acquis*, started on October 20, 2005 and carried on until October 13, 2006. Screening is the preparatory stage to accession negotiations. The screening process is carried out jointly by the Commission and each of the candidate countries. A further purpose of screening is to identify the areas of the *acquis* in which progress is needed if the candidate countries' legislations are to be compatible with the Community rules. These areas are divided into chapters, which are negotiated individually and the EU *acquis* is composed of approximately 120 thousand pages.

At this screening process with Turkey, the policy issues have been broken down into 35 policy areas (chapters). Each chapter needs to be unanimously opened and closed by the Council. The 16th Chapter is devoted to 'Taxation'. The screening process is formed at two different stages. The first one is 'explanatory screening' and the second one is 'bilateral meeting'. At the explanatory screening, the Commission gives information about the related chapter to the candidate countries. At the phase of bilateral meeting, the candidate country gives information on whether it can accept the relevant chapter of the acquis, whether it has the administrative structures and other capacity to implement the acquis properly; if not when they will be put in place and whether it intends to request transitional arrangements in the chapter under review. In this respect, explanatory screening of Turkey for the taxation chapter was held on June 6-7, 2006 in Brussels. In these meetings the EU Commission informed the Turkish authorities about the EU tax legislation. The second phase was held on

July 11-12, 2006 in Brussels and during this time, the Turkish side gave information about the legal framework of the taxation in Turkey and told about the administrative capacity of Turkish Revenue Administration, which is the responsible institution of tax revenues.

Currently, the screening process has been accomplished on taxation chapter. The Commission sends a 'Draft Screening Report on Taxation' to Turkish Revenue Administration and requires the Turkey's adjustments about the whole report, excluding the Chapter of 'Assessment of the Degree of Alignment and Implementing Capacity'. The screening reports are submitted to the candidate countries after finalizing each chapter's screening procedures. The assessments and suggestions in a screening report are proved to be the main basis for whether to open that chapter to negotiations or not. The Commission evaluates these reports on whether the candidate country is ready for negotiations or not, depending on the information given by that country. At the conclusion part of these reports, the Commission either suggests opening the negotiations for that chapter or introducing the 'benchmarks'. After consulting Turkey and adding her adjustments, the 'Screening Report on Chapter 16- Taxation[1]' was published. So, the screening process for taxation chapter was finalized. But it can be clearly said that there is a long road ahead for Turkey.

Within this context, the main aim of this thesis is to provide a thorough comparative analysis between the EU and Turkey taxation policies, especially in the field of value-added tax. The main focus will be given to VAT due to the fact that the VAT is the most important area among the taxes needed to be harmonized in the European Union context. Taking into consideration that there is a wide *acquis* concerning VAT, the harmonization issue on this topic is likely to come to the agenda in the negotiating process as a significant step for Turkey. On the other hand, it can be clearly said that in terms of revenues the most important indirect tax in Turkey is VAT. In 2006, the total VAT revenue is 41.336.800.000- NTL which is 30.0 % of

[1]European Commission, (2007), 'Screening Report of Turkey, Chapter 16 - Taxation', is available at 'http://ec.europa.eu/enlargement/turkey/screening_reports_en.htm', (accessed on 10.08.2007).

the total tax revenues. While the amount of 15.911.290.000-NTL is domestic VAT, 25.425.510.000-NTL is VAT on importation. Comparing the shares of personal income tax (21%) and corporate income tax (8.1%) with that of VAT, in total tax revenues, it can be seen that even their sum (29.1%) is lower than that of VAT[2]. While this thesis mainly aims to study the legal aspect of the VAT legislation, these figures illustrate that legal arrangements in the field of VAT, for example an upward arrangement in the reduced rates, would probably influence the economic life, especially the relative prices in the country. Furthermore, VAT is important for being a significant revenue item for the European Union budget. The revenue of the European Union budget comes from three main sources; customs duties, a share of the harmonised VAT base of each member state and a further contribution from the member states based on the size of their gross national income. The resource based on VAT is a uniform percentage rate that is applied to each member state's harmonised VAT revenue. The VAT-based resource accounts for 15 % of total revenue, or some EUR 17.8 billion[3]. On the other hand, it can be clearly stated that the VAT revenue of each member state of the EU is also have an important share in view of their contribution to the Gross Domestic Product (GDP)[4]. So, in terms of European Union context, VAT is an important topic to be considered.

The main contribution of this thesis is to make a comparative analysis of VAT legislations of the European Union and Turkey, by using the recent legislation sources in this field. The Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax entered into force on 1 January 2007. Therefore, it is the most recent development in the VAT field in Europe. In this sense, the main motivation of this thesis is to determine the differences between the

[2] The amounts are available at 'http://www.muhasebat.gov.tr/mbulten/T10-12-2.xls', (accessed on 20.07.2007).

[3] The figures are available at 'http://ec.europa.eu/budget/budget_glance/where_from_en.htm', (accessed on 17.09.2007).

[4] See for a detailed analysis and figures on the 'Breakdown of Tax Revenue by Country and by Main Tax Categories (of % GDP)', Lena Frej Ohlsson, (2005), 'Tax Revenue in EU Member States', *Statistics in Focus*, p.7., is available at 'http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-NJ-05-003/EN/KS-NJ-05-003-EN.PDF', (accessed on 19.09.2007).

two VAT legislations through the meeting notes and reports of screening process of taxation chapter, which also constitute the recent primary sources. Therefore, it can be clearly stated that the main accomplishment of this thesis is to study the recent sources concerning VAT in a detailed judicial framework.

In order to give background information, EU tax policy will be examined as a separate issue and the legal basis of tax harmonization in the EU context will be studied as well. The thesis mainly examines the differences between the EU and Turkish VAT legislations taking into account the fact that harmonization of the Turkish tax legislation with that of the EU is amongst the priorities for Turkey during the accession negotiations. The thesis primarily argues that there would be no binding benchmarks on VAT at this stage.

After examining the VAT legislation of the EU, the thesis will try to identify the same topics in the Turkish VAT legislation. Within this framework, areas that need further focus will be enlightened and recommendations will be made.

To start with, EU tax policy will be discussed in the Second Chapter. Within this context, Chapter 2 aims to set the general framework of the EU's tax policy, and proceeds in four parts. The aim of the first part is to outline the literature survey on tax harmonization in the EU. Second part intends to make a general assessment in the context of developing EU tax policy. The third part focuses on the principles of EU tax policy and after that the general objectives of the EU tax policy will be scrutinized. Mechanisms to achieve these EU tax policy objectives are examined separately under this part due to the fact that understanding the logic and legal framework of the EU tax policy is important for harmonizing our tax policy with that of the EU. The last part of this chapter intends to give information about recent EU developments in the field of taxation.

Chapter 3 focuses on the EU tax harmonization in terms of its legal basis. The legal framework will be examined under three parts. The first one is primary sources. In

this part, all of the related articles of the EC Treaty will be studied in detail. The second part states the basic features of the types of secondary sources - regulation, directive, decision, recommendation, opinion, resolution- on the basis of their binding forces. After examining the types of secondary EU tax law, the thesis analyzes harmonized measures of EU secondary tax law. This analysis will be made under three titles, conflict rules, limitation on national legislative power by clauses and optional rights of member states.

The main aim of the thesis starts to illustrate itself in Chapter 4. This chapter especially focuses on the VAT legislation of the EU. The Council Directive 2006/112/EC[5] of 28 November 2006 on the common system of value added tax, called as the constitution of the VAT issue in the EU, will be examined topic by topic. In this context, the screening process highlights these topics, considering the areas needed for further analysis. These topics are determined as the subject matter and scope of VAT, taxable person, taxable amount, exemptions, the right of deduction, chargeable event and rates. The same topics are scrutinized in the Fifth Chapter, in terms of Turkish VAT legislation. While the Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax is taken as the base for the EU side, the Turkish VAT Law, No.3065 is the primary source for illustrating the legal aspects of the VAT in Turkey.

Finally, the comparison of VAT legislation in the EU and Turkey will be made in Chapter 6. This comparison will focus on the areas in which the EU approach has shown a certain impact. In this respect the European Commission recommendations on the issue of VAT through the Screening Report will be stated in Chapter 7 which is the conclusion part of this thesis. All in all, this thesis will try to develop some recommendations based on its findings, in this last chapter.

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[5] The Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, (2006), Official Journal (OJ) of the European Union L 347/1, Vol.49, is available at 'http://eurlex.europa.eu/LexUriServ/site/en/oj/2006/l_347/l_34720061211en00010118.pdf', (accessed on 23.08.2007).

CHAPTER II
EUROPEAN UNION TAX POLICY

While economic integration within the European Union (EU) progresses, the interactions between different tax systems of the member states have gained importance. Since the emergence of the EU, it has been debated whether a fully integrated market needs a harmonization of national tax policies within the EU or not. But it is a fact that, from the beginning, taxation has been seen as a 'sovereignty' issue and EU member states have mostly been in favour of protecting their sovereignty in the area of taxation. The main reason for the difficulties in forming a fully harmonized EU tax policy is the existing differences among national preferences for tax strategies - in order to regulate public consumption and income redistribution- due to varieties in history, culture and economic problems across the EU member states. Another reason of the susceptibility on the issue of tax harmonization is the fact that taxes constitute the most substantial part of the budget revenues. So, tax harmonization issue is on the agenda as a choice between the loss of national tax autonomy and potential gains from well functioning cross border economic activities.

For a detailed analysis on the subject of tax harmonization, although taxes have changed a lot in form, it is useful to classify them as 'direct taxes' – such as corporate and personal income tax, and 'indirect taxes'- such as value-added tax and special consumption tax. In general, taxes on individuals and corporations are regarded as direct taxes; while taxes on goods and transactions are considered as indirect taxes. The government collects direct tax from the individuals (legal or natural) on which it is levied. Indirect taxes are levied on production or consumption. An indirect tax (such as value added tax (VAT), or goods and services tax (GST)) is a tax collected by an intermediary from the person who bears the ultimate economic burden of the tax (such as the customer). The intermediary later files a tax return and forwards the tax proceeds to government with the return. In this sense, the term indirect tax is contrasted with a direct tax which is collected directly by government

from the persons (legal or natural) on which it is imposed. In this sense it can be said that taxable persons are collecting the indirect taxes on behalf of the government. So, the attention should be given to the shifting of indirect taxes. Because, the most important difference between these two types of taxes (direct and indirect) is the 'shifting of indirect taxes'. Indirect taxes are shifted forward from the firms – importers and domestic sellers- to the consumers of the product taxed[6]. This shifting assumption is based on the consideration that these levies constitute an increase in the cost of providing the goods and services, affecting the competing firms more or less uniformly[7]. It is charged at all stages of production. The most important feature of VAT is its deduction mechanism. It means that while sellers are required to charge the tax on all of their sales, they can also claim a credit for taxes that have been charged on their inputs[8].

While indirect taxes call for a high degree of harmonization as they directly affect the free movement of goods and services, the same cannot be said for direct taxes. The Treaty Establishing the European Community (EC Treaty)[9], does not make a specific provision for the alignment of direct taxation. By signing the EC Treaty the founding members committed themselves to 'promote throughout the Community a harmonious, balanced and sustainable development of economic activities' and '…a high degree of competitiveness' (Article 2 of EC Treaty). The member states achieve these goals by establishing an internal market. According to the EC Treaty, 'the internal market shall comprise an area without internal frontiers in which the free

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[6] John Due, (1988), 'The Role of Indirect Taxation', *Indirect Taxation in Developing Countries*, Baltimore and London: The Johns Hopkins University Press, p.19.

[7] John Due, (1988), p.19.

[8] L. Ebrill, M. Keen, J. Bodin and V. Summers, (2001), 'The Nature, Importance, and Spread of the VAT', *The Modern VAT*, Washington, D.C.: International Monetary Fund, p.3.

[9] The Treaty of Rome refers to the treaty which established the European Economic Community (EEC) and was signed by France, West Germany, Italy, Belgium, the Netherlands and Luxembourg on March 25, 1957. Its original full name was Treaty Establishing the European Economic Community. However the Treaty of Maastricht amended it and among other things removed the word "Economic" from the name of both the community and the treaty. The "EC Treaty" then became a short form of the name.

movement of goods, persons, services and capital is ensured...' (Article 14/2 of EC Treaty). For the purposes of creating an internal market the EC Treaty specifies the obligations of the Community, fulfilment of which is essential for carrying out this project (Article 3 of EC Treaty). These obligations include the harmonization of member state laws which are necessary for the establishment and functioning of the internal market. Recognizing the major role of taxation in the integration process, the founding members of the EU devoted a separate chapter (Chapter 2) to tax provisions in the EC Treaty. Articles 90 to 92 of Chapter 2 specify the general prohibition on discriminatory taxation and other types of protectionist measures. Article 93 sets up the competence of the Community to harmonize the national indirect taxes. The reason for emphasizing indirect taxes lies in the fact that these taxes, including VAT, are levied on products and therefore have an immediate effect on international flow of goods and services.

2.1. Tax Harmonization: A Literature Survey

The literature on tax harmonization has been shaped by three central notions: tax competition, tax harmonization and tax coordination. The main question is which one of the above notions serves as the best solution to the development of the internal market and to closer economic integration?

Being an important figure in the field of tax competition, Tanzi explains the tax issues from the perspective of globalization. According to him, implication of globalization is that many national policies are having effects beyond a country's borders. Thus, it tends to create frictions between the development due to globalization and traditional, national policies or institutions. This conflict characterizes many policy areas and is becoming particularly strong in taxation[10]. The ongoing debate on taxation within the European Union is the evidence of this

[10] Vito Tanzi, (1996), 'Globalization, Tax Competition and the Future of Tax Systems', *IMF Working Paper,* p.4, available at 'http://papers.ssrn.com/sol3/papers.cfm?abstract_id=883038', (accessed on 03.03.2007).

conflict[11]. He argues that this is an issue having worldwide significance. Globalization and the progressive integration of world economies have been changing the environment. Presently, the actions of many governments are greatly constrained or influenced by the actions of other governments, and spillover-effects across frontiers generated by taxation have become common and important. This has opened the possibility for some countries to take advantage of this new situation by attracting a larger share of the world tax base, thus exporting some of their tax burden[12]. So, he implies that tax competition has become a fact of life for many countries and the net effect of such a competition is or will be a reduction in tax revenue for many countries and a forced change in the structure of their tax systems[13]. Consequently, he concludes that tax competition is likely to induce some countries to reduce their effective tax rates in order to attract capital[14].

In the literature in terms of the arguments in favour of tax competition; measures to limit tax competition through 'harmonization' or 'cooperation' are regarded as the tools that lead to formation of 'tax cartels'[15], using monopoly power to maximize revenues. Areas of cartelization, in any case, tend to become uncompetitive.

On the other hand, there are arguments for limiting tax competition in favour of harmonization or coordination. In terms of the tax harmonization concept, many scholars in this field reveal the notion of tax harmonization into a definition. For instance, it has been suggested that harmonization refers to 'international equalization of effective tax rates', implying a serious loss of national fiscal autonomy. With cross-country differences in economic structures and political

[11] Vito Tanzi, (1996), p.4.

[12] Vito Tanzi, (1996), p.5.

[13] Vito Tanzi, (1996), p.12.

[14] Vito Tanzi, (1996), p.16.

[15] Ben Patterson, (2002), 'Tax Co-ordination in the EU: The Latest Position', *European Parliament, Directorate-General for Research Working Paper,* Economic Affairs Series, Luxembourg, p.69.

preferences, complete harmonization of the most important taxes may involve a substantial welfare loss[16]. By contrast, tax coordination aims to prevent distortions and inequities arising from over taxation or under taxation of cross-border economic activities, while respecting as far as possible the desires of nation states to choose their own preferred size of the public sector and their own preferred structure of taxation[17].

As far as 'tax harmonization' is concerned, Sijbren Cnossen, being one of the important authors in this field, asserts that;

> as economic integration within the EU progresses, the interactions between the tax systems of the member states are of growing importance. Member state tax policies can have spillover or externality effects, positive or negative, on other member states. Similarly, differing abilities to provide net fiscal benefits to residents may impair the efficient allocation of productive factors across member states. Furthermore, separate tax mechanisms increase administrative and compliance complexity and costs for governments and taxpayers, and constrain member states in pursuing redistributive tax policies.[18]

These considerations have important implications for the design and coordination of tax systems in the EU. As Kay points out, there is 'integration through harmonization' and 'integration through competition'[19]. According to first approach – which he calls the Bismarckian approach – the creation of the internal market requires prior alignment of the tax policies and practices of the member states. Under

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[16] Peter Birch Sørensen, (2001), 'Do We Need Tax Coordination?', *D.A. Albregtse, A.L. Bovenberg and L.G.M. Stevens (eds.), Er Zal Geheven Worden (Taxes Shall be Levied!), Liber Amicorum in Honour of Sijbren Cnossen*, Kluwer, p.3, is available at 'http://www.econ.ku.dk/pbs/diversefiler/cnossen.pdf', (accessed on 24.01.2007).

[17] Peter Birch Sørensen, (2001), p.3.

[18] Sijbren Cnossen, (2002) 'Tax Policy in the European Union: A Review of Issues and Options', *Center for Economic Studies (CESIFO) Working Paper,* No.758, p.3, is available at 'http://papers.ssrn.com/sol3', (accessed on 17.11.2005).

[19] John Kay, (1993), 'Taxation Policy and Economic Integration', *Taxation in the United States and Europe: Theory and Practice,* New York, NY: St Martin's Press, p.156.

the second approach – the Jeffersonian approach – the mechanism of choice promotes integration at all deliberate speed and to let the consequences for the tax rules follow from that. In essence, the choice is between prescription and adaptation, a choice that has deep historic roots in Europe[20]. Cnossen refers to Bird in his article and states that there are two related but quite separate dimensions of integration, the economic and the political (as expressed by, among others, tax integration)[21]. His review of the actual situation in the EU common market shows that there is no single consensus between the economic and the political dimensions of taxation. In practice, economic union can exist quite separately without much political or tax integration[22]. As he states, 'economic union is not a degenerate case of federalism'. Further, he continues: 'just as in federations, identical tax systems may be neither necessary nor desirable in a common market in which member states have different policy objectives and different economic conditions'[23].

In his view, the 'differential' approach instead of the 'equalization' approach seems the most appropriate in principle.

The contrast between tax harmonization, which may reduce economic distortions, and tax competition, which may reduce political distortions, is explored by Frey and Eichenberger[24]. As the authors states; 'neoclassical public economists stress economic distortions induced by differential taxation and therefore favour

[20] Sijbren Cnossen, (2002), p.79.

[21] Sijbren Cnossen, (2002), p.79, Bird, R.M., (1989), Tax Harmonization in Federations and Common Markets, in M. Neumann and K.W. Roskamp, eds, *Public Finance and Performance of Enterprises*, Detroit, MI: Wayne State University Press.

[22] Sijbren Cnossen, (2002), p.79, Bird, R.M., (1989).

[23] Sijbren Cnossen, (2002), p.79.

[24] Frey, B. and R. Eichenberger, (1996), 'To Harmonize or to Compete? That's Not the Question', *Journal of Public Economics*, p.1.

harmonization; political economists focus on political distortions and therefore reject harmonization'[25].

As the question of 'taxation within the EU' has become a crucial one, another issue flourished in the literature. This concern springs from a general acknowledgement that, 'increased integration within the Union will pressure tax rates among member states to converge at some point'. As factor mobility increases within the EU, pressure will be placed on member states to lower their tax rates on mobile factors in order to attract business. This uncontrolled competition will lead to a very low tax rate that threatens countries' abilities to supply public goods. Scholars such as Oates predict that;

> the result of tax competition may well be a tendency toward less than the efficient levels of outputs of local public services. In an attempt to keep tax rates low to attract business investment, local officials may hold spending below those levels for which marginal benefits equal marginal costs.[26]

This general idea is also reflected by Zodrow and Mieszkowski, who cite a shortage of public goods as the result of mobile capital and tax competition. These scholars would clearly support some set of strict rules that harmonize taxes at a level high enough to ensure the continuity of public goods[27].

On the other hand, there are some authors who support the idea that while a full harmonization is unnecessary, a tax base would be advisable. Being one of those authors, Krogstrup states that '… there is a margin within which a positive tax rate can be applied on capital, which does not induce an outflow of capital'[28]. In this

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[25] Frey, B. and R. Eichenberger, (1996), p.1.

[26] Oates, W.E., (1972), *Fiscal Federalism*, New York: Harcourt Brace Jovanovich, p.130-158.

[27] George R. Zodrow and Peter Mieszkowski, (1984), 'Pigou, Tiebout, Property Taxation, and the Underprovision of Local Public Goods', *Journal of Urban Economics*, p.356-370, is available at 'http://www.lrz-muenchen.de/~ces/systems-ws06-07/Zodrow%20JUrbanEconomics.pdf', (accessed on 10.08.2006).

[28] Signe Krogstrup, (2002), 'What do Theories of Tax Competition Predict for Capital Taxes in EU Countries? A Review of the Tax Competition Literature', *HEI Working Paper*, 05:2002, p.24, is

sense, his claim is supported by the reality that, ‘capital taxes have not fallen over the last 20 years in the European Union, in spite of the fact that capital mobility increased dramatically’ and ‘EU average tax revenues from corporate taxation increased during the last 20 years, both in percent of GDP and in percent of total tax revenues’[29]. Krogstrup also notes the ability to increase taxes on non-mobile factors without harming overall tax revenues. He focuses on source and residence principle in his studies. In this sense, as it is explained in Sinn’s article, source principle briefly means that while non-residents receiving income derived from the source (country) are not subject to tax, incomes earned at source are taxable and residence principle means that income is subject to tax only in individual’s country of residence, regardless of where his income is generated[30]. In addition, EU members can exercise the option of ‘not always taxing capital at the source principle but also according to the residence principle’[31]. Nevertheless, he accepts that, ‘overall, a downward pressure on tax rates is still present’[32]. While Krogstrup does not provide a certain formula based on his findings, he clearly mentions that full-fledged harmonization is unnecessary; a tax floor would be advisable.

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available at ‘http://hei.unige.ch/sections/ec/pdfs/Working_papers/HEIWP05-2002.pdf’, (accessed on 10.08.2006).

[29] Signe Krogstrup, (2003), ‘A Synthesis of Recent Developments in the Theory of Capital Tax Competition’, *EPRU Working Paper,* 02:2004, p.2, is available at ‘http://www.econ.ku.dk/epru/files/wp/wp-04-02.pdf’, (accessed on 10.08.2006).

[30] Hans Werner Sinn, (1992), ‘The Case for European Tax Harmonization’, *Tax Harmonization and Financial Liberalization in Europe*, Proceedings of Conferences held by the Confederation of European Economic Associations in 1989, St.Martin’s Press, p.4.

[31] Signe Krogstrup, (2002), p.24.

[32] Signe Krogstrup, (2002), p.24.

Baldwin and Krugman's study supports this argument. Like Krogstrup, they assert that, 'simple tax harmonization always harms at least one nation and adoption of a rate between two unharmonized rates harms both nations'[33].

On the other hand, there are some scholars who consider any sort of tax regulation as inefficient. These scholars can be divided into two sub-groups: proponents of loose coordination between countries, and proponents of unchecked tax competition[34].

First we shall review the arguments supporting loose coordination as the best solution to the tax question. In their paper, Razin and Sadka support a basic principle in favour of coordination between member countries. They first introduce a scenario that is 'of particular relevance for Europe', in which member countries are recently faced with the prospect of tax competition[35]. They argue that;

> if the competing countries are sufficiently coordinated with the rest of the region so as to be able to effectively tax their residents on their income from capital in the rest of the region, then tax competition leads each country to apply the residence principle of taxation and the equilibrium outcome is efficient.[36]

This simply implies that EU members can establish a common tax policy that eliminates the need for strict harmonization in the face of tax competition. The arguments presented by loose coordination proponents state that '….thus, there are

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[33] R.Baldwin and P. Krugman, (2000), 'Agglomeration, Integration, and Tax Harmonization' *CEPR Discussion Paper*, No:2630, p.1, is available at 'http://www.wcfia.harvard.edu/seminars/pegroup/baldwinkrugman.pdf', (accessed on 10.08.2006).

[34] Tom Stults, (2004), 'Tax Harmonization versus Tax Competition: A Review of the Literature', is available at 'http://economics.about.com/cs/moffattentries/a/harmonization_4.htm', (accessed on 10.08.2006).

[35] A. Razin and E. Sadka, (1989) 'International Tax Competition and Gains from Tax Harmonization' *NBER Working Paper*, No. 3152, p.3.

[36] A. Razin and E. Sadka, (1989), p.4.

gains for the competing countries from tax coordination with the rest of the world.[37]. Similar to the rest of the literature reviewed, Razin and Sadka clearly recognize the potential downward pressures of tax competition on mobile capital; they are nonetheless unique in promoting simple coordination within the EU as the most effective solution.

There are other opinions that consider interaction between member countries as a sufficient guarantor of tax stability. Fourçans and Warin, who use a game theoretical approach to predict the outcome of the European tax situation, emphasize that interactions within the EU protect against harmful tax competition, therefore rendering any superfluous additional tax harmonization rules. The authors question the EU's harmonization strategy, where taxes on savings will face 'a minimum common rate of 15% until 2004, then 20% until the end of 2009…'[38]. According to them, 'as monetary policy is 'federalized', and as fiscal policy is constrained by the Stability and Growth Pact[39], taxation becomes the last macroeconomic instrument within governments' hands to deal with asymmetric shocks'[40]. With this in mind, tax harmonization appears overly restrictive. Yet the argument continues by indicating that even a minimum tax floor may be unnecessary.

Another perspective on the taxation question has acquired a shape at the sphere of 'entirely unhindered tax competition'. This viewpoint obviously opposes to the

[37] A. Razin and E. Sadka, (1989), p.4.

[38] A. Fourçans and T. Warin, (2001), 'Tax Harmonization versus Tax Competition in Europe: A Game Theoretical Approach', *CREFÉ Working Paper*, No. 132, p.3, available at 'http://www.economie.uqam.ca/CREFE/cahiers/cah132.pdf', (accessed on 10.08.2006).

[39] The Stability and Growth Pact (SGP): It is an agreement by European Union member states related to their conduct of fiscal policy, to facilitate and maintain Economic and Monetary Union of the European Union. It is based on Articles 99/1 and 104/2 of the European Community Treaty (with the amendments adopted in 1993 in Maastricht), and related decisions. It consists of fiscal monitoring, and sanctions against offending members. The pact was adopted in 1997, so that fiscal discipline would be maintained and enforced in the EMU. It is available at 'http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm', (accessed on 04.06.2007).

[40] A. Fourçans and T. Warin, (2001), p.4.

supporters of strict tax harmonization, whereas the rest of the literature supports a grey area between tax harmonization and competition. The logic of the argument favouring tax competition is simple: tax competition will reduce government revenues, and by being forced to maintain sound public finances, governments will reduce their inefficient spending. This body of literature derives its support from conservative policymakers and public choice theorists, who assert that, 'competition in general, and competition among governments in particular, is beneficial because it reduces government waste and disciplines politicians'[41]. This reasoning is also supported by Boss who argues that if tax rates are cut in the process of competition, government expenditures have to be reduced and this helps to avoid waste and inefficiencies in the public sector[42].

Janeba and Schjelderup share this viewpoint while examining the influence of increasing capital mobility. The authors conclude that increasing competition is likely to improve voter utility[43]. In addition to this, the EU members' (mostly) parliamentary systems are compared to the US presidential-congressional system, and it is claimed that, 'parliamentary democracies have higher taxes, higher public goods provision, and higher government waste'[44]. This provides further support for the argument that reductions in EU member government revenues may indeed be welfare-increasing.

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[41] E. Janeba and G. Schjelderup, (2004) 'Why Europe Should Love Tax Competition - and the U.S. Even More So', *NBER Working Paper,*No. 9334, p.2, is available at 'http://www.nhh.no/sam/res-publ/2004/23.pdf', (accessed on 12.08.2006).

[42] Alfred Boss, (1999), 'Do We Need Tax Harmonization in the EU?', *Kiel Institute Working Paper* No. 916, p.1, is available from abstract at 'http://ideas.repec.org/p/kie/kieliw/916.html', (accessed on 12.08.2006).

[43] E. Janeba and G. Schjelderup, (2004), p.3.

[44] E. Janeba and G. Schjelderup, (2004), p.3.

Finally it can be clearly asserted that taxation within the EU is a subject that is by no means consensual. It can be easily said that the literature on European tax coordination and tax harmonization is enormous and many of the problems involved are highly complex[45]. So, it can be asserted that there is a general consensus on the pressures facing EU members, and a recognition that the tax issue and the notion of tax harmonization have been on the table since the Treaty of Rome, and will likely remain there for quite some time. Yet, what the literature does positively establish is that harmonization is not necessary. It can obviously be seen from the practical process of EU integration that, a large part of EU tax policies in the direct tax field does not aim harmonizing member states' tax rules. It can be easily said that EU tries to ensure the coordination of tax policies; meaning that EU aims to ensure that the member states' tax systems are mutually compatible and that they respect the European treaties. Consequently, provided that member states respect Union rules, they are free to choose their own tax systems.

Consequently, 'harmonization' means taking required legal and administrative measures in order to avoid elements distorting smooth functioning of single market. Legal and administrative arrangements do not refer to remove all of the differences among the legal orders. The aim is the revision of the national laws and making the required amendments in the view of establishment and functioning of a single market. In this sense 'tax harmonization' can be defined as cooperation of the states in the area of taxation to achieve the economic integration or customs union. In a brief context, the arrangements in the way of tax harmonization aim to keep tax neutralization in the free movement of goods and capital. In this sense it can be asserted that tax harmonization implies the studies to ensure the parallelism in the field of taxation. 'Tax harmonization' is used as an instrument in economic integration. So, it is not a common policy in the EU. This point is also very clear in

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[45] Peter B. Sørensen, (2001), 'Tax Coordination in the European Union: What are the Issues?', *Revised Version of paper presented at the conference on Macroeconomic Policy Co-ordination in the EU: Haw Far Should It Go?' organized by the Economic Council of Sweden*, Stockholm, p.2, is available at 'http://www.ekonomiskaradet.se/Panda_ekonomiska/Data/Documents/sepr2001/', (accessed on 12.08.2006).

the EC Treaty. While the Article 93 of the EC Treaty mentions ‘harmonization of legislation’, Article 94 refers to ‘approximation of laws’. The difference between these two methods is the fact that while ‘harmonization’ is related to the essence of the law and expresses the absorbing of contradictions; ‘approximation’ refers to an action in order to make national laws similar[46].

2.2. The General Context for Developing European Union Tax Policy

Globalization, growing trade and capital flows require the EU policies that develop the EU’s competitiveness in the global economy. Especially, the development of e-commerce increases the mobility of economic activities and the mobility of capital. Businesses in the EU increasingly operate in more than one member state and there are more international mergers between companies than ever before.

In this changing environment, EU tax systems must be fairly flexible and simple in order to minimize the compliance costs and eliminate tax barriers to the free movement of capital and tax measures that distort competition. Additionally, different tax systems at the EU level must be transparent. This urgency is derived from the need of minimizing the tax fraud and tax evasion. Another reason for the existence of principles of ‘simplicity’ and ‘transparency’ is the fact that tax systems are used as tools for resource allocation, redistribution and stabilization objectives. In this respect, while the main aim of the resource allocation, a classical function of budgetary policy, can be defined as ensuring to meet public needs; discretion and desirable redistribution of national income is arranged by redistribution function[47]. On the other hand, the objective of stabilization is to determine the measures

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[46] See also for a detailed analysis about the relation between the concepts of ‘harmonization’, ‘approximation’ and ‘coordination’; Michele Vozza, (2006), ‘Harmonization, Approximation, or Coordination? The Effect of ECJ Jurisprudence on Taxation’, is available at ‘http://www.ssi.unitn.it/en/dottorato/download/Research_Proposal_Michele_Vozza.pdf’, (accessed on 06.07.2007).

[47] Richard A. Musgrave, (1958), *Kamu Maliyesi Teorisi: Kamu Ekonomisi Alanında Bir İnceleme*, Ankara, Asil Yayıncılık, p.6-7.

required in order to carry on necessary level of total demand[48]. The most reasonable way to prevent the tax fraud is information exchange and cross-border cooperation. These two tools also result in more efficient tax collection. It should also be noted that exchange of information and co-operation between taxation administrations are seen as the most important instruments that allow for such coordination and to avoid tax frauds. Additionally, these two instruments both respect the sovereignty of cooperating countries and allow them to apply their own tax rules, which they consider appropriate, to their taxpayers.

The need for progress in tax co-ordination in the EU and a comprehensive view of taxation policy depends on three main motivations: stabilization of member states' tax revenues, smooth functioning of the internal market and promoting employment[49].

Stabilization of Member States' Tax Revenues; Fair competition is a key component of the single market, but unfair competition in the tax area is a cause of concern because of its potential negative effects, particularly on tax revenues of member states, on the efficient allocation of economic resources within the EU, and on competitiveness and employment[50]. On the other hand, liberalization has increased the opportunities for tax fraud and thus helped to cause many tax avoidance and evasion cases in many countries in the world. For example, the differences between national value-added tax legislations lead to tax fraud. Because of this tax fraud, instability is observed on the member state's revenues.

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[48] Richard A. Musgrave, (1958), p.6.

[49] Commission of the European Communities, (2001), 'Communication from the Commission to the Council, The European Parliament and the European Economic and Social Committee Tax Policy in the EU Priorities for the Years Ahead', Brussels, COM (2001) 260 final (23.05.2001) p.3, is available at 'http://eur-lex.europa.eu/LexUriServ/site/en/com/2001/com2001_0260en01.pdf', (accessed on 10.06.2006).

[50] Commission of the European Communities, (1996), 'Taxation in the European Union', Brussels, SEC(96) 487 final (20.03.1996), p.5, is available at 'http://ec.europa.eu/taxation_customs/resources/ documents/ taxation_sec(1996)487_en.pdf', (accessed on 10.06.2006).

Smooth Functioning of the Internal Market; The single market takes place at the centre of European integration. It gains an important meaning especially with four fundamental freedoms of movement. Additionally, it has a crucial role in strengthening the Economic and Monetary Union (EMU) of the EU and the Union's competitiveness. With the single market, the EU aims to promote sustainable growth and stimulate employment. As other regulatory and economic barriers are progressively removed, taxation is rightly perceived as an increasingly important residual factor preventing the full realization of internal market[51].

Promoting Employment; One of the objectives of the 'White Paper on Growth, Competitiveness and Employment' is to put an end to the over taxation of labour in order to promote employment within the EU. So as to avoid large budget deficits, member states have supported either finding alternative revenue sources or cutting expenditures to fund the costs of reducing labour taxation. The choice for alternative funding includes indirect taxation (VAT and excise duties); capital and real property taxation; and new or increased environmental or energy taxes[52]. In this context, the harmonization of taxation issue gains importance.

2.3. Principles for European Union Tax Policy

There exist three main principles in the framework of the EU tax policy: subsidiarity, tax neutrality and unanimity.

Subsidiarity:

'Subsidiarity' is a central issue in the Treaty of Rome, and it tells that there should be action only at EU level where action by individual member states can not provide an

[51] SEC(96) 487 final, p.6.

[52] SEC(96) 487 final, p.8.

effective solution. In taxation, subsidiarity seems to have three distinct but related dimensions[53].

First and foremost, subsidiarity in an interdependent EU means that member states should cooperate to establish the rules of the taxation and basically, these rules should regard the compromise of competing claims to the same tax base[54]. It means that the tax bases have to be agreed upon and properly formulated. In this sense, unambiguous definitions and practices of subsidiarity principle (i.e. transparency) are essential[55].

Secondly, and no less importantly, subsidiarity means that member states should be able to control the level of revenue *at the margin*; that is, they must be able to set the level of taxes to correspond to the desires of voters[56].

Thirdly, the member states should be able to operate their own tax systems, designed in accordance with the agreed rules, without the need for day-to-day cooperation with other member states in the form of information exchange, cross-border audits, etc. which infringes on subsidiarity[57].

On the other hand, Bovenberg, Cnossen and de Mooij discuss the issues and options faced by the EU member states in dealing with the trade-offs between tax subsidiarity and fiscal neutrality. Tax subsidiarity implies a large measure of tax

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[53] Sijbren Cnossen, (2002), p.11.

[54] Sijbren Cnossen, (2002), p.11.

[55] Sijbren Cnossen, (2002), p.11.

[56] Sijbren Cnossen, (2002), p.11.

[57] Sijbren Cnossen, (2002), p.11.

autonomy, while fiscal neutrality appears to require a substantial degree of harmonization[58].

Tax Neutrality:

It is argued that tax considerations should not guide international trade, factor movements and the location of production. For this reason inter-country fiscal affairs should be based on tax neutrality. That is, the flows of goods, services, people, capital and the international specialization in production should be the same with and without taxes[59]. Also it can be described as a characteristic that taxes interfere with the natural flow of capital toward its most productive use.

There are two main important issues raised against the notion of tax neutrality. The first is its ambiguous meaning. But, consequently, it is said that the most neutral tax system is the system that does least to distort the market pattern of capital movements or other elements of economic activity[60]. The second one is that a neutral tax is a tax that will leave the market exactly the same as it was without taxation. But, in this sense, it can be said that no tax can be truly neutral. Neutrality can be achieved only in a purely free market, where government revenues are obtained according to voluntary payment principle[61].

Lastly, on the issue of the 'neutrality', it should be emphasized that the general aim of tax harmonization is fiscal neutrality, defined as equal treatment for domestic production and imports from member countries.

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[58] L. Bovenberg, S. Cnossen and R. de Mooij, (2003), 'Introduction: Tax Coordination in the European Union', *International Tax and Public Finance*, 10:619-624, Netherlands, Kluwer Academic Publishers, p.619.

[59] Theo Hitiris, (2004), 'Tax Harmonization', *European Union Economics*, vol. 5, England, p.106.

[60] Barry Bracewell-Milnes, (1976), 'A Liberal Tax Policy; Tax Neutrality and Freedom of Choice', *The British Tax Review*, No:2, p.1, is available at 'http://www.libertarian.co.uk/lapubs/econn/', (accessed on 28.10.2006).

[61] Barry Bracewell-Milnes, (1976), p.1.

Unanimity:

The last principle on which taxation in EU countries is based is 'unanimity'. According to this principle, EU-wide taxation matters can only be adopted by a unanimous vote of member states. Considering the literature, it should be stated that retaining unanimity for all taxation decisions makes it difficult to achieve any of the tax coordination necessary for Europe. So, in the literature it is argued that qualified majority voting[62] must be necessary in certain tax areas.

2.4. General Objectives of European Union Tax Policy

As a priority, EU tax policy must serve the interests of citizens and corporations in terms of their four freedoms in the internal market (free movement of goods, people, capital and services). It also focuses on the removal of tax obstacles in terms of these four freedoms.

Three main objectives can be emphasized in EU taxation. The first one is the simplification of the tax system in order to make different tax systems of the member states more accessible to the taxpayers[63]. The second one is broadening the tax base, and the third one is the removal of tax barriers to contribute to the competitiveness of the EU.

More specifically, the first one is simplifying and modernizing the tax administrative rules and procedures with which member states have to comply. Kovacs, commissioner for taxation and customs union, in his speech in 2006, states that 'one

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[62] Qualified Majority Voting: According to the procedure, each member state has a fixed number of votes in the Council of the European Union. The number allocated to each country is roughly determined by its population, but progressively weighted in favour of smaller countries. To pass a vote by QMV, both of the following conditions must apply: First, the proposal must be backed by a majority of member states (or two thirds in certain cases); secondly, the proposal must be supported by 255 votes from a total of 345 - about 73.91% of the votes. Dan S. Felsenthal, Moshé Machover, (2005), 'Qualified Majority Voting Explained', is available at ' http://www.nottingham.ac.uk/economics/research/seminars/papers/26-01-05-machover.pdf', (accessed on 07.07.2007).

[63] COM (2001) 260 final, p.7.

of the ways the EU reinforces the single market is to cut out the inefficiencies inherent in tax obstacles by preventing them from hindering cross-border activities'[64]. According to him, in order to make Europe a more attractive environment for investment and for employment, tax system must enable the businesses to take full advantage of the single market. This means focusing on eliminating those inefficiencies due to the coexistence of 27 different tax systems across the EU and simplifying them.

Secondly, as called for in the Broad Economic Policy Guidelines (BEPGs)[65], for the 2003-2005 period, EU tax policy should continue to facilitate efforts to cut nominal rates while broadening the tax base, thus reducing the economic distortions associated with member states' tax systems. The issue of 'tax base' is especially related with the area of corporate tax. The Commission has established as one of its priorities in the taxation field the creation of a 'common consolidated corporate taxation base' in the EU. The Commission considers that if companies were allowed to apply a single EU-wide set of rules for company tax purposes, this would eliminate most of the current problems such as double taxation that they currently face when they do business across borders in the EU. It would also lead to a substantial reduction in compliance costs. This idea has received considerable support from the business sector, as well as from many member states[66].

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[64] Laszlo Kovacs, (2006), 'The European Commission's Business Taxation Agenda', *Oxford Center for Business Taxation*, Oxford, p.2, is available at 'http://ec.europa.eu/commission/barroso/kovacs/speeches/OXFORD_speech.pdf', (accessed on 20.12.2006).

[65] European Commission Directorate - General for Economic and Financial Affairs, (2004), 'Broad Economic Policy Guidelines for the 2003-05 Period', No: 4/2004, is available at 'http://ec.europa.eu/economy_finance/publications/european_economy/2004/ee404en.pdf', (accessed on 20.12.2006).

[66] Laszlo Kovacs, (2005), 'EU Tax Policy - State of Play and Perspectives', *Speech of at the Plenary Session of the Economic and the Social Committee on EU Taxation Policy*, p.2, is available at 'http://ec.europa.eu/commission_barroso/kovacs/speeches/eu_tax_policy_plenary_session.pdf', (accessed on 10.11.2006).

The last objective is removal of tax barriers. Tax distortions, compliance and administrative burdens on tax payers and tax administrations can be seen as tax barriers.

The existence of different national tax systems in the EU represents a sizeable source of extra cost in terms of administrative tax compliance[67]. Indeed, differences between member states' tax rules mean that firms may prefer to operate domestically rather than in another member state. These are important difficulties to achieve the smooth functioning of competitive internal market. The removal of these barriers would help to create new opportunities for market competition.

2.4.1. Instruments for the Objectives of European Union Tax Policy

On the issue of the instruments for general objectives of the EU tax policy, the main point is the scope of EU tax harmonization. From both the technical and theoretical point of view, it can be clearly asserted that there is no need for a broad harmonization of member states' tax systems. Therefore, it is essential to underline that in many tax fields, harmonization is neither necessary nor desirable in view of the widely differing characteristics of member states' tax systems and different national preferences.

But a high degree of harmonization is essential in the indirect tax field. The Treaty specifically provides an indirect tax harmonization (Article 93), because indirect taxes may create an immediate obstacle to the free movement of goods and the free supply of services within an internal market. They may also create distortions of competition. A large number of directives and regulations have already been agreed

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[67] Commission of the European Communities, (2005), 'Implementation of the Community Lisbon Programme Communication from the Commission to the Council and The European Parliament, 'The Contribution of Taxation and Customs Policies to the Lisbon Strategy', COM (2005) 532 final, p.4, is available at 'http://ec.europa.eu/taxation_customs/resources/documents/COMM_PDF_COM_2005_0532_F_EN_ACTE.pdf', (accessed on 10.11.2006).

in this area. The Commission's legislative strategy, particularly with respect to VAT as well as environmental and energy taxation, has been clearly established[68].

'As far as taxes on personal income are concerned, the view is that such taxes may be left to member states even when the European Union achieves a higher level of integration than at present'[69]. Nevertheless, the fundamental EC Treaty principles must be respected by member states especially on non-discrimination. In the context of instruments for the objectives of the EU tax policy, it can be stated that using the coordination of national tax systems as an instrument in the area of personal income will probably emerge as an important issue.

2.4.2. Mechanisms to Achieve the Objectives of European Union Tax Policy

There are three mechanisms that can be mentioned to achieve the objectives of the EU tax policy: decision-making process, infringement proceedings and 'soft law' instruments.

2.4.2.1. Decision-making Process

In order to achieve progress in the tax field, the Commission has relied, generally, on making proposals for directives and sometimes for regulations. Directives and regulations are adopted only after full discussion in the Council, the European Parliament and the Economic and Social Committee. Besides, directives and regulations offer legal certainty due to the fact that they may be enforced by the European Court of Justice[70].

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[68] COM (2001) 260 final, p.8.

[69] COM (2001) 260 final, p.8.

[70] COM (2001) 260 final, p.20.

However, in the literature, it is argued that the process for directive proposals in the tax field has been slow. This disappointing progress phase is taking on a shape around the principle of unanimity, which means that when taking decisions on some issues, the Council of the European Union has to be in unanimous agreement – i.e. all countries have to agree. In this sense, any disagreement, even by one single country, may block the decision. This would make progress very difficult in a Union of 27 countries, so the unanimity rule now applies only in particularly sensitive areas such as asylum, taxation and the common foreign and security policy. In most fields, decisions are now taken by qualified majority voting. Therefore, ideas are being discussed on the possible creation of a new mechanism to co-ordinate tax issues in the framework of the Council.

But there are some good developments in this area. One of them is the fact that decisions on proposals in the area of mutual assistance and administrative co-operation are taken in the Council by a qualified majority rather than by unanimity is one of them. However, it remains the Commission's view that a move to qualified majority voting at least for certain tax issues is indispensable[71].

2.4.2.2. Infringement Proceedings

Another tool for eliminating the tax obstacles is to develop the infringement proceedings; because, there are many areas where member states' tax rules may violate Community tax legislation.

In this sense the Commission's role in the field of infringement proceedings has to be noted. Under the treaties, the European Commission has the role of developing the rules and ensuring correct application of the legal order. The role of the Commission is very important, because as being the defender and the guardian of the European law, it preserves the essence of the European project. It is not just taxpayers who take

[71] COM (2001) 260 final, p.21.

cases to the European Court of Justice; the Commission is also required to take legal actions against member states whose tax rules infringe the European Community's *acquis*. The Commission submits its observations to the Court of Justice about the tax cases brought by taxpayers. But it rarely brings the infringement proceedings against member states in the field of taxation. So, it can clearly be said that the Commission should aim to adopt a more active strategy in the field of tax infringements and should pay closer attention to member states, especially in cases in which it believes that Community law is broken.

The Commission initiates infringement proceedings when it considers that a member state violates its treaty obligations depending on the power provided in Article 226[72] of the EC Treaty. The Commission starts the process by inviting that member state to provide explanations for the violation. If the Commission considers these explanations as insufficient, it gives a time limit within which the member state must take the measures to comply with the obligations. When this time limit is not followed by the appropriate action, the case is taken before the ECJ.

Article 227[73] of the EC Treaty explains the central role played by the Commission. It deals with infringement proceedings introduced by one member state against another.

[72] Article 226 of the EC Treaty states that 'If the Commission considers that a Member State has failed to fulfill an obligation under this Treaty, it shall deliver a reasoned opinion on the matter after giving the State concerned the opportunity to submit its observations. If the State concerned does not comply with the opinion within the period laid down by the Commission, the latter may bring the matter before the Court of Justice.'

[73] Article 227 of the EC Treaty states that 'A Member State which considers that another Member State has failed to fulfill an obligation under this Treaty may bring the matter before the Court of Justice. Before a Member State brings an action against another Member State for an alleged infringement of an obligation under this Treaty, it shall bring the matter before the Commission. The Commission shall deliver a reasoned opinion after each of the States concerned has been given the opportunity to submit its own case and its observations on the other party's case both orally and in writing. If the Commission has not delivered an opinion within three months of the date on which the matter was brought before it, the absence of such opinion shall not prevent the matter from being brought before the Court of Justice.'

Parallel to the development of EU legislation, the European Court of Justice (ECJ) has also taken an important place in the EU infringement proceedings. European multinationals are increasingly challenging member states' tax rules and the ECJ becomes increasingly active in terms of tax rules violating the EC Treaty or other European legislations. The ECJ has to deal with disputes between member states as well as cases concerning interpretation and application of the EC Treaty[74]. One of the main features of this Court is the fact that its competence is obligatory. It means that when a country joins the EU, it has to accept its authority.

The role of the ECJ shows itself especially in the Article 228[75] of the EC Treaty. According to this article, the state concerned 'shall take the necessary measures to comply with the judgment of the Court of Justice'.

2.4.2.3. 'Soft Law' Instruments

As a recent development, the EU has improved a new regulatory policy, focusing on the use of alternative instruments. Main aim of broadening the use of soft law instruments is fundamentally inspired by the concern to enhance the effectiveness, legitimacy and transparency of EU action. The use of 'soft law' approaches may also be an alternative tool in the area of taxation. In this context some important developments should be expressed. In the field of taxation, in 1998, the conclusions

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[74] Renaud Dehousse, (1988), *The European Court of Justice, The Politics of Judicial Integration*, St. Martin's Press, New York, p.18.

[75] Article 228 of the EC Treaty states that, '1. If the Court of Justice finds that a Member State has failed to fulfill an obligation under this Treaty, the State shall be required to take the necessary measures to comply with the judgment of the Court of Justice. 2.If the Commission considers that the Member State concerned has not taken such measures it shall, after giving that State the opportunity to submit its observations, issue a reasoned opinion specifying the points on which the Member State concerned has not complied with the judgment of the Court of Justice. If the Member State concerned fails to take the necessary measures to comply with the Court's judgment within the time limit laid down by the Commission, the latter may bring the case before the Court of Justice. In so doing it shall specify the amount of the lump sum or penalty payment to be paid by the Member State concerned which it considers appropriate in the circumstances. If the Court of Justice finds that the Member State concerned has not complied with its judgment it may impose a lump sum or penalty payment on it. This procedure shall be without prejudice to Article 227'.

of the Economic and Financial Affairs Council (ECOFIN) meeting of 1 December 1997 concerning taxation policy were published, and the 'Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation' was attached to it[76]. Later, Communication named 'Tax Policy in the European Union - Priorities for the Years Ahead' was adopted and it was stated that 'the use of non-legislative approaches' or 'soft legislation' may be an additional means of making progress in the tax field[77]. Reference is made in this respect to instruments such as communications, recommendations, guidelines and notices in this Communication. All of these soft law instruments can be classified under three categories according to Senden[78]. The first major category is 'preparatory and informative instruments'[79]. The main function of these instruments are to prepare further Union law or policy and provide information on Community action. A second category of soft-law instruments is 'interpretative and decisional instruments'[80]. These instruments aim at providing guidance as to the interpretation and application of existing Community law, especially on the basis of the case law of the ECJ. This category mainly includes the instruments such as Commission's communications, notices, guidelines, codes and frameworks. The third category covers 'steering instruments'[81]. Steering instruments aim to establish or improve Community objectives and policies, often with recommendations, resolutions and codes of conduct, non-binding acts, which have not legal force, but have a political weight.

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[76] Council of European Union, Council Resolution of 9 March 1998 concerning the establishment of the Code of Conduct Group (business taxation), O J C 099, 01.04.1998, p.1-2, is available at 'http://eur- lex.europa.eu/smartapi/cgi/sg', (accessed on 28.08.2007).

[77] COM (2001) 260 final, p.10.

[78] Linda Senden, (2005), 'Soft Law, Self Regulation, Co-Regulation in European Law: Where Do They Meet?', *Electronic Journal of Comparative Law*, vol. 9.1, p.23, is available at 'http://www.ejcl.org', (accessed 28.08.2007).

[79] Linda Senden, (2005), p.23.

[80] Linda Senden, (2005), p.24.

[81] Linda Senden, (2005), p.24.

In this sense, following advantages of using these soft law instruments can be stated. First, these instruments can assist to enhance new tax rules. Secondly, these instruments can indicate the potential legal problems and designate the possible ways for dealing with these legal conflicts.

2.5. Recent Developments in the Field of Taxation in the European Union

With the enlargement, it becomes vital to ensure that taxation does not prevent member states from being able to compete or from taking the advantages of the full benefits of the internal market. In this sense, the European Commission aims to animate 'The Lisbon Strategy' in 2005[82]. Lisbon Strategy is an action and development plan for the European Union, which was set out by the European Council in Lisbon in March 2000[83]. The Agenda includes reforms intended to implement the EU's strategic goal to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion. The Commission has initiated a plan for EU-wide taxation measures that would help the EU in order to achieve its Lisbon objectives. For this reason, The Commission has prepared a Communication[84] that will present the key Community taxation measures that would contribute to fulfilling the Lisbon taxation strategies. The main initiatives in the area of taxation can be summarized as; a common consolidated corporate tax base for EU businesses, simplifying the tax environment, targeted measures to remove cross-border tax barriers faced by EU firms, a new strategy for car taxation, reducing distortions created through tax fraud and tax evasion, modernizing VAT rules, tax

[82] Commission of the European Communities, (2005), 'Working Together for Growth and Jobs- A New Start for the Lisbon Strategy', Com (2005) 24 final, Brussels, available at 'http://eur-lex.europa.eu/LexUriServ/site/en/com/2005/com2005_0024en01.pdf', (accessed on 10.08.2006).

[83] The Lisbon European Council, (2000), 'An Agenda of Economic and Social Renewal for Europe', DOC/00/7, Brussels, is available at 'http://www.europarl.europa.eu/summits/lis1_en.htm, (accessed on 20.06.2007).

[84] COM (2005) 532 final.

incentives reducing the cost of research and development, energy, transport and environment related taxes[85].

On the other hand globalisation presents significant challenges which require a comprehensive strategy on the taxation side. Taxation reforms, carried by the EU, have been driven by several factors such as high unemployment rates and low participation rates, simplification of taxation systems, ageing and globalisation. The excessive tax burden on labour has led EU member states to move towards a more employment-friendly labour taxation[86]. Additionally, member states have tried to rationalise and simplify their tax systems, by broadening the tax base in order to reduce the tax rates.

Lastly, it should be noted that technological improvements will lead EU focusing on an issue of cooperation between tax systems of member states in order to prevent tax fraud and tax evasion. The main focus will be given on the issue of administrative cooperation, concerning the tax and customs administrations of EU member states cooperating with one another to share information. It is almost seen as the fact that close cooperation between these bodies is vital to detect and reduce tax fraud, however facilitating information exchange between the member states will become more effective in the near future.

[85] COM (2005) 532 final, p.5-15.

[86] G. Carone, G.Nicodeme, J.Schmidt, (2007), 'Tax Revenues in the European Union: Recent Trends and Challenges Ahead', *European Economy- Economic Papers,* p.2., 25. is available at 'http://mpra.ub.uni-muenchen.de/3996/01/MPRA_paper_3996.pdf', (accessed on 28.08.2007).

CHAPTER III

TAX HARMONIZATION AND EUROPEAN UNION TAX LAW

Since its inception with the Treaty of Rome in 1957, the EU has had an impact on tax law. Although the Treaty of Rome itself contained few provisions concerned with tax, and these were directed mainly at the elimination of tax discrimination on the importation and exportation of goods, the Community institutions soon turned their attention to tax harmonization.

First, it can be clearly stated from the outset that EU tax policy is a matter of harmonizing tax law and not a matter of unification. The Neumark Report of 1962 explicitly justifies this point. In 1960, the Commission appointed the Fiscal and Financial Committee to study the extent to which the tax systems of the member states conflicted with the establishment of a common market[87]. The Committee was chaired by Professor Neumark and the 1962 report of the Committee is generally referred to as the Neumark Report. The Neumark report is an example for the early reports, which also addresses issues of direct taxation, but such measures were not adopted until much later.

On the basis of the Neumark Report, in November 1962 the Commission submitted to the Council a draft directive on a common system of value-added tax[88]. Subsequently, the first and second VAT directives were adopted by the Council in 1967.

[87] Nami Çağan, (1991), *Avrupa Topluluğu Vergi Politikasının Hukuki Çerçevesi*, Ankara Üniversitesi Avrupa Topluluğu Araştırma ve Uygulama Merkezi, 2.Bası, Ankara, Ankara Üniversitesi Yayıncılık, p.21.

[88] P. Farmer and R. Lyal, (1994), *EC Tax Law*, Clarendon Press, Oxford, p.17.

Another phase of European tax policy was initiated by the Commission's 1985 White Paper[89]. It outlined the existing physical, technical and tax barriers to free movement of goods, people and capital and proposed measures for the elimination of those barriers[90].

The Single European Act[91] of 1987 represents perhaps the most significant step toward European economic integration[92]. Under the authority of the Act, the EC Council of Ministers was expected to approve nearly 300 provisions that would dismantle physical barriers (customs and passport control), technical barriers (regulatory restrictions that affect trade, and financial and real factor flows) and fiscal barriers (border controls involving indirect taxation) among member states, by the end of 1992[93].

At this stage of market integration, the Commission looked for how a single market should function. Goods and services and people should move freely from one member state to the other in the way they can within a member state. Therefore, a transition from 'destination principle' to 'origin principle' seems logical. According to 'destination principle', commodities are taxed in the country of destination (that is

[89] Commission of the European Communities, (1985), 'Completing the Internal Market – White Paper from the Commission to European Council', COM (85) 310 final, is available at 'http://europa.eu/documents/comm/white_papers/pdf/com1985_0310_f_en.pdf', (accessed on 07.07.2007).

[90] P. Farmer and R. Lyal, (1994), p.27.

[91] Single European Act (SEA); signed in Luxembourg on 17 February 1986, it is the first major amendment of the Treaty of Rome. It entered into force on 1 July 1987. The main aim was to remove remaining barriers between countries, increase harmonization and the competitiveness of European countries. It reformed the operating procedures of the institutions and qualified majority voting was extended to new areas. 'Single European Act', is available at 'http://europa.eu/scadplus/treaties/singleact_en.htm', (accessed on 28.07.2007).

[92] George Kopits, (1992), *Tax Harmonization in the EC Policy Issues and Analysis*, IMF, Washington D.C., p.1.

[93] George Kopits, (1992), p.1.

where they are consumed), regardless of where they are produced[94]. The EU adopts this principle in the area of indirect taxes[95]. Destination principle ensures that exports are exempt from tax and imports are subject to tax. An alternative to the destination principle is 'origin principle'. According to this principle, commodities should be taxed on the basis of their place of production, regardless of where they are consumed. Additionally, imports are not taxed and no rebate is given with respect to exports[96]. In other words, in the field of direct taxes, the state in which the goods and services are produced is authorized[97]. Although the 'destination principle' is more appropriate for the movement of goods in the EU, it already has not been adopted due to the fact that reconcilment can not be ensured among the member states[98]. So, 'destination principle' can be summarized as the main principle at the moment while some arrangements have been adopted as of January 1993. The period, since 1993, is called as 'transitional period' and has been going on.

Generally, today the taxation of goods and services is primarily governed by the EU law under the common system of VAT. Excise duties and transport taxes are harmonized to some extent. Some aspects of company taxation are subject to common rules, while others may require consultation between tax authorities. Finally, there are some provisions in the EU tax law for the exchange of information between the tax authorities of the member states and for cooperation in recovering tax debts.

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[94] A. Lans Bovenberg and Jocelyn P. Horne, (1992), 'Taxes on Commodities', *Tax Harmonization in the EC Policy Issues and Analysis,* IMF, Washington D.C., p.22.

[95] Nami Çağan, (1991), p.44.

[96] A. Lans Bovenberg and Jocelyn P. Horne, (1992), p.22.

[97] Nami Çağan, (1991), p.44.

[98] See also for a detailed analysis on the movements of goods in the EU and VAT, Nurettin Bilici, (2004), *Türkiye Avrupa Birliği İlişkileri –Genel Bilgiler, İktisadi-Mali Konular, Vergilendirme*, Seçkin Yayıncılık, Ankara, p.150-154.

3.1. Legal Basis of Tax Harmonization

There are three main sources of European tax law. The first one is provisions concerning the tax included in the EC Treaty, its annexes and protocols, and they constitute the 'primary sources' of the EU Law. The second one is secondary (or derivative) sources, composed of legal instruments based on the EC Treaty and include unilateral secondary law and conventions and agreements. The third source is the decisions of Court of Justice, which is known as the basic judgment institution of the EU. Its main task is to ensure interpretation and application of the EC Treaty.

3.1.1. Primary Sources

European action in the area of taxation has its legal basis in Article 90- 96 of the EC Treaty. The EC Treaty is the only primary legal source of the tax harmonization. Recognizing the major role of taxation in the integration process, the founding members of the Community devoted a separate chapter to tax provisions in the Treaty. These main tax provisions are in Common Rules on Competition, Taxation and Approximation of Laws (Title VI) of Part III of the Treaty (Community Policies). They especially deal with indirect taxation, but their position in the Treaty shows that they are directed not only at the free movement of goods but more generally at the achievement of the Community's objective as a whole[99].

Articles 90 and 91 ensure border tax adjustment. Article 90 stipulates the general prohibition on discriminatory taxation and other types of protectionist measures. Article 90 states that;

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[99] P. Farmer and R. Lyal, (1994), p.6.

> no Member State shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products. Furthermore, no Member State shall impose on the products of other Member States any internal taxation of such a nature as to afford indirect protection to other products. (Article 90 of the EC Treaty)

Article 91 states that 'where products are exported to the territory of any Member State, any repayment of internal taxation shall not exceed the internal taxation imposed on them whether directly or indirectly' (Article 91 of the EC Treaty).

The function of Article 90 in the scheme of the Treaty is twofold[100]. First of all, it complements the other provisions of the Treaty aimed at ensuring free movement of goods[101]. These provisions are Articles 9 – 32 of the EC Treaty. Articles 9 to 27 establish the Customs Union; prohibit custom duties on imports and exports and all charges having equivalent effect in trade between member states. Articles 28 to 32 prohibit quantitative restrictions and all measures having equivalent effect in trade between member states. Due to the fact that these provisions do not suffice to prevent protectionism, Article 90 serves to eliminate fiscal barriers to trade. Secondly, Article 90 seeks to ensure complete neutrality of internal taxation as between imports and domestic products[102]. By this way it aims to ensure equal treatment to domestic and foreign products in order to eliminate unfair competition.

Article 92 lays down a provision for eliminating discrimination in the taxation of imports and exports. It ensures the implementation of the 'destination principle'.

Article 93 gives the Council the power to adopt legislation for the harmonization of national law on turnover taxes, excise duties and other forms of indirect taxation[103].

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[100] P. Farmer and R. Lyal, (1994), p.35.

[101] P. Farmer and R. Lyal, (1994), p.35.

[102] P. Farmer and R. Lyal, (1994), p.35.

[103] P. Farmer and R. Lyal, (1994), p.6.

The legal basis for the existing legislation on VAT depends on this article. A large number of directives and regulations (i.e. 'secondary legislation') have already been agreed in this area on the basis of Article 93, which stipulates that;

> the Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonization of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonization is necessary to ensure the establishment and the functioning of the internal market within the time limit laid down in Article 14. (Article 93 of the EC Treaty)

As far as other taxes are concerned, Article 94 provides for the Council, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, to adopt provisions for the approximation of such laws, regulations or administrative provisions of the member states as directly affect the establishment or functioning of the common market (Article 94 of the EC Treaty).

The Council has the authority to adopt directives for the *approximation* of the national laws with the Articles 94 and 96 of the EC Treaty. Article 94 allows the Council to legislate in relation to provisions which 'directly effect' the establishment or functioning of the common market[104]. With the Article 94, the Council gains competence in adopting legislation on direct taxation. Additionally, it should be noted that both Articles 93 and 94 require the Council to act unanimously.

Article 95, introduced by the Single European Act, allows the Council to act by a qualified majority in adopting measures concerning the establishment or functioning of the internal market, but fiscal provisions are expressly excluded from the scope of this procedural relaxation[105].

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[104] P. Farmer and R. Lyal, (1994), p.7.

[105] P. Farmer and R. Lyal, (1994), p.7.

Member states have also adopted EU-wide legislation in the field of mutual assistance and co-operation in tax matters, under Articles 93, 94 or 95 of the EC Treaty.

Under Article 96, the Council adopts directives or other appropriate measures, if there is a distortion of competition. The main emphasis of this article is derived from the fact that it allows the Council to act by a qualified majority rather than unanimously. Article 96 states that;

> where the Commission finds that a difference between the provisions laid down by law, regulation or administrative action in Member States is distorting the conditions of competition in the common market and that the resultant distortion needs to be eliminated, it shall consult the Member States concerned. If such consultation does not result in an agreement eliminating the distortion in question, the Council shall, on a proposal from the Commission, acting by a qualified majority, issue the necessary directives. The Commission and the Council may take any other appropriate measures provided for in this Treaty. (Article 96 of the EC Treaty)

Community legislation on taxation has also been adopted under wider provisions of the Treaty. Article 293 of the EC Treaty requires member states to enter into negotiations with each other with a view to the abolition of double taxation within the Community. Finally Article 308 should be explained. It does not directly include tax elements, but it is a general provision which gives the Council authority to adopt legislation for which no specific powers are granted else-where in the Treaty but which appears necessary in order to achieve one of the objectives of the Community[106].

On the other hand, many provisions dealing with other areas of community may have tax implications. Examples are Article 12, which prohibits discrimination on grounds of nationality in matters within the scope of the Treaty, Article 39 on freedom of movement for workers, Article 43 on freedom of establishment, Article 49 on freedom to provide services, Article 72 on transport, and Article 294 on equal

[106] P. Farmer and R. Lyal, (1994), p.8.

treatment of foreign investors. The provisions on state aids in Articles 87 to 89 prevent member states from granting tax exemptions or concessions as a form of subsidy to national industries.

In this framework, member states' tax systems must respect the fundamental EC Treaty principles on the free movement of workers, services and capital and the freedom of establishment (Articles 39, 43, 49 and 56 of the EC Treaty) and the principle of non-discrimination.

3.1.2. Secondary Sources

EU secondary tax law is the law of an international organization addressing issues of international tax law among states[107]. As far as EU secondary law is concerned, Article 249 of the EC Treaty is the main article related with legal arrangements such as regulations, directives, decisions, recommendations, opinions and resolutions.

A **regulation** is a legislative act of the European Union which is directly applicable in all member states and obligatory with all its elements. Regulations are taking place among the most powerful forms of EU law because of having equivalent effect with national laws. They become to be a part of domestic law in member states without the need to enact implementing measures. It means that member states do not need to pass domestic laws to bring them into effect. Consequently, new legislation enacted by member states must be consistent with the requirements of EU regulations. There are two types of regulations in the EU: 'basic regulations' and 'execution regulations'. Basic regulations establish essential rules governing a certain matter, and are normally adopted by the Council[108]. Execution regulations technically organize these principles; they are usually taken by the European Commission or the Council acting

[107] Kirsten Borgsmit, (2003), ‘EU Tax Policy and Characteristics of EU Secondary Tax Law’, *European Business Law Review*, Vol.14, No:2, p.165, is available at ‘www.kluwerlawonline.com/toc.php?area=Journals&mode=bypub&level=6&values=Journals’, (accessed on 17.05.2007).

[108] Nurettin Bilici, (2004), p.108.

on the basis of Article 211[109]. One of the examples for the EU regulation in the area of VAT is Council Regulation (EC) 1798/2003 on administrative cooperation in the field of value added tax and repealing Regulation (EEC) No 218/92.

A **directive** is a legislative act of the European Union which requires member states to achieve a particular result without dictating the means of achieving that result[110]. Directives come into force not directly, but only through legal act or decrees adopted by member states while EU regulations do not require any implementing measures. Directives are only binding on the member states to which they are addressed. However, in practice, directives are generally addressed to all member states. One of the most important directives in the field of VAT was Sixth Council Directive of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment (77/388/EEC).

A European Union **decision** is a secondary law instrument which does not have general application, but only applies to its particular addressee of the decision (i.e. to a member state, a company or an individual). Council Decision of 3 December 1990 authorizing the Federal Republic of Germany to grant an exemption from Articles 14 and 15 of the Sixth Directive 77/388/EEC on the harmonization of the laws of the Member States relating to turnover taxes for Soviet armed forces stationed on the territory of the Federal Republic of Germany (90/640/EEC) can be given as an example for decisions.

A **recommendation** in the European Union is one of two kinds of non-binding acts cited in the EC Treaty[111]. Although recommendations do not have legal force, they have a political weight. According to the terms of the EC Treaty; 'in order to ensure

[109] Nurettin Bilici, (2004), p.108.

[110] Nurettin Bilici, (2004), p.108.

[111] Nurettin Bilici, (2004), p.108.

the proper functioning and development of the common market, the Commission (…) formulates recommendations or delivers opinions on matters dealt with in this Treaty, if it expressively so provides or if the Commission considers it necessary'. An example that can be given is Council Recommendation of the European Parliament and of the Council of 30 May 2002 concerning the implementation of Integrated Coastal Zone Management in Europe (2002/413/EC).

An **opinion** in the European Union is also a non-binding instrument situated in the EC Treaty. It generally implies a desire. An example that can be used for an opinion is 'Commission Opinion on the existence of an excessive deficit in Portugal - Application of Article 104/5 of the Treaty establishing the European Community' (SEC/2005/0991).

On the other hand, the EU institutions publish some texts, called as **resolutions**, on different issues in order to explain its contention. Council Resolution of 15 September 1986 on improving energy efficiency in industrial firms in the Member States (86/C 240/01) can be given as an example.

After examining the types of secondary EU tax law, an alternative way of analyzing harmonized measures of EU secondary tax law, made by Borgsmit[112] should be mentioned. This analysis can be summarized under three titles:

1) Conflict rules regarding the competence of member states,
2) Limitation on national legislative power by clauses,
3) Optional Rights of Member States.

1) Conflict rules regarding the competence of member states: Conflict rules provide answers to the question where to tax, but not to the question whether or not to tax[113]. Harmonised conflict rules protect economic operators against double taxation. The

[112] Kirsten Borgsmit, (2003), p.165-181.

[113] Kirsten Borgsmit, (2003), p.165.

aim of conflict rules is to avoid conflicts of jurisdiction between member states. Harmonised conflict rules set out the points of reference which allocate tax power to a member state and designate the applicable national law. Article 24 of the Council Directive 2006/112/EC can be stated as an example of the harmonized conflict rules. As far as supply of services is concerned, since the beginning, the taxation of the supply of services has not been subject to border tax adjustment. For determining the place of supply, Article 43 of the Council Directive 2006/112/EC provides that;

> the place where a service is supplied shall be deemed to be the place where the supplier has established his business or has a fixed establishment from which the service is supplied or, in the absence of such a place of business or fixed establishment, the place where he has his permanent address or usually resides.

In this sense, where the supplier has established his/her business is a primary point of reference. Briefly, it can be said that conflict rules are designed to provide an answer to the question where to tax by way of determining the point of reference which then constitutes a concept of Union law subject to uniform interpretation by the ECJ thus excluding double taxation of transborder transactions[114].

2) Limitation on National Legislative Power by Clauses: The freedom of action of the national legal arrangements is restrained by harmonization measures. The scope of these restrictions is identified by the clauses in Community law. Two clauses can be mentioned:

a) Standstill Clauses: Standstill clauses are set up at the beginning of a convergence process to prevent further divergences from developing but allow existing divergences. There are some standstill clauses in the EU secondary tax law. The 6th VAT Directive left some questions open, so standstill clauses were used in order to postpone agreement up till a certain date[115]. Article 17 (6) of the 6th VAT Directive concerning the exclusions from the right to deduct VAT can be given as an example

[114] Kirsten Borgsmit, (2003), p.171.

[115] Kirsten Borgsmit, (2003), p.172.

in order to illustrate the issue. In such cases of standstill clauses, member states are entitled to keep their legislation even after expiry of the time limit. Article 17 (6) provided that;

> before a period of four years at the latest has elapsed from the date of entry into force of this Directive, the Council, acting unanimously on a proposal from the Commission, shall decide what expenditure shall not be eligible for a deduction of value added tax. Value added tax shall in no circumstances be deductible on expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainment. Until the above rules come into force, Member States may retain all the exclusions provided for under their national laws when this Directive comes into force. (Article 17/6 of the 6th VAT Directive)

It can be stated that under the second paragraph of Article 17/6, the principle of the right to deduct VAT was subject to the derogation in Article 17/6 of the Sixth Directive. It means that the member states can keep their existing legislation as of the date on entry into force of the Sixth Directive. After the entry into force of the Sixth Directive, some amendments should be made in the legislation of member states in order to reduce the scope of existing exemptions. By this way member states comply with the objective of the Sixth Directive.

b) Preclusive Clauses: Sometimes the Union legislator inserts a preclusive clause in the directive providing guidance to the scope of the limitative effect of the harmonisation measures[116]. A preclusive clause is used for providing this guidance. The importance of preclusive clauses is therefore that they apply to other national taxes which are not based on harmonized measures to ensure that other national tax measures do not jeopardize the *acquis communautaire* of harmonized tax measure[117]. Article 401 of the Council Directive/2006/112/EC is an example of preclusive clauses. It states that;

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[116] Kirsten Borgsmit, (2003), p.173.

[117] Kirsten Borgsmit, (2003), p.173.

> without prejudice to other provisions of Community law, this Directive shall not prevent a Member State from maintaining or introducing taxes on insurance contracts, taxes on betting and gambling, excise duties, stamp duties or, more generally, any taxes, duties or charges which cannot be characterised as turnover taxes, provided that the collecting of those taxes, duties or charges does not give rise, in trade between Member States, to formalities connected with the crossing of frontiers. (Article 401 of the Council Directive/2006/112/EC)

The purpose of Article 401 is to prevent jeopardizing the functioning of the common system of VAT by the introduction of taxes, duties or charges levied on the movement of goods and services in a way comparable to VAT.

3) Optional Rights of Member States: Options represent a reduced number of variations existing in member states at the time of the adoption of the harmonizing measure[118]. To make a choice among the options is the exclusive right of member states. When a member state makes its choice that provision becomes binding.

Consequently, it can be clearly said that there is a harmonized community tax law only to a limited extent and member states have their own legislative power. In the context of general tax law, while it can be stated that there exists a comparatively limited harmonization, existing of a particular broad harmonization in the field of value added tax can be expressed. Especially with the adoption of the Council Directive/2006/112/EC (the VAT Directive), the fact that a situation, representing more harmonization in the field of VAT, that comes to the European Union arena can be expressed.

3.1.3. European Court of Justice's Case Law

For the interpretation of the Union VAT legislation, the case law of the European Court of Justice (ECJ) is a crucial element. Especially in the area of indirect taxation, there are some restriction provisions in order to ensure preventing four fundamental

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[118] Kirsten Borgsmit, (2003), p.177.

freedoms (free movements of goods, services, labour and capital) and free competition provisions of the EC Treaty. Therefore, domestic legal arrangements have to comply with the EU tax law. In this sense, the ECJ has an important role through being the only interpreter of the EU law.

The ECJ, the judicial institution of the EU, was set up in 1952 in Luxembourg. Its aim is to make sure that EU legislation is interpreted and applied in the same way in all EU countries. It ensures, for example, that national courts do not give different rulings on the same issue. The ECJ has the power to settle legal disputes between EU member states, EU institutions, businesses and individuals. Through its case-law, the ECJ has identified an obligation on administrations and national courts to apply Community law in full within their sphere of competence and to protect the rights conferred on citizens by that law (*direct application of Community law*). However, the ECJ has also identified an obligation to misapply any conflicting national provision, to the Community provision (*primacy of Community law over national law*)[119].

In its case-law (starting with van Gend and Loos in 1963[120]), the Court has introduced the application of 'principle of direct effect of Community law' in the member states. The principle is conducting an obligation to member states' courts to apply the Community law in full and to protect the rights conferred on citizens by the law.

[119] 'The Court of Justice of the European Communities', is available at 'http://www.curia.europa.eu/en/instit/presentationfr/index_cje.htm', (accessed on 10.05.2007).

[120] European Court of Justice, (1963), Judgment of the Court of 5 February 1963, '*NV Algemene Transport- en Expeditie Onderneming van Gend & Loos v Netherlands Inland Revenue Administration',* Case 26-62, European Court Reports English special edition, p.1, is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&lg=en&numdoc=61962J0026', (accessed on 27.08.2007).

In interpreting the Community VAT legislation, the Court has relied heavily on the 'teleological' method of interpretation[121]. It means that the ECJ has paid close attention to descriptions in directives and to the considerations set out in the preambles of the directives, in particular the aim of achieving a tax which is neutral in domestic and intra-Community trade[122].

The ECJ has used the technique of giving independence to Community law meanings to basic terms, such as the 'supply of goods' and 'supply of services', in order to ensure a uniform interpretation of the legislation[123].

The ECJ has also led great emphasis on the contextual or schematic method of interpretation[124]. It means that the function of the individual provisions of the VAT legislation is often best understood when they are read together with other provisions.

Lastly, it should be expressed that the ECJ has been given clearly defined jurisdiction in order to enable properly to fulfil its task, which it exercises on references for preliminary rulings, actions for annulment and appeals. Preliminary rulings implies the fact that in order to ensure the effective and uniform application of Community legislation and to prevent divergent interpretations, the national courts may, and sometimes must, refer to the Court of Justice and ask it to clarify a point concerning the interpretation of Community law, so that they may ascertain, for example,

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[121] P. Farmer and R. Lyal, (1994), p.89.

[122] 'A system of VAT achieves the highest degree of simplicity and of neutrality when the tax is levied in as general a manner as possible and when its scope covers all stages of production and distribution and the provision of services' fifth recital in the preamble of the First Council Directive 67/227/EEC of 11 April 1967 on 'the harmonisation of legislation of Member States concerning turnover taxes', available at 'http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31967L0227:EN', (accessed on 10.05.2007).

[123] P. Farmer and R. Lyal, (1994), p.90.

[124] P. Farmer and R. Lyal, (1994), p.90.

whether their national legislation complies with that law[125]. By an action for annulment, the applicant seeks the annulment of a measure (regulation, directive or decision) adopted by an institution, on which the ECJ has exclusive jurisdiction. Appeals may be brought before the ECJ against judgments and orders of the Court of First Instance[126].

3.2. General Framework of Tax Harmonization in the European Union

The issue of tax harmonization in the EU consists of two different components. The first one is direct taxation, which remains the sole responsibility of member states. The second one is indirect taxation, which affects free movement of goods and the freedom to provide services. Tax policy ensures that competition between member states on the internal market is not distorted by differences in indirect tax systems.

3.2.1. Harmonization of Direct Taxes

With regard to direct taxation, member states have taken measures to prevent tax avoidance and double taxation. Unlike indirect taxes, the EC Treaty does not specifically call for direct taxes to be harmonised. In any case national direct tax rules must respect the fundamental freedoms determined in the EC Treaty. In the field of direct taxes, one of the most important areas, in terms of harmonization, is company taxation.

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[125] The Court of Justice of European Communities; The Various Types of Proceedings', is available at 'http://curia.europa.eu/en/instit/presentationfr/index_cje.htm', (accessed on 28.08.2007).

[126] The Court of First Instance: It is made up of at least one judge from each member state. The judges are appointed by agreement of the member state governments for a renewable mandate of six years. They appoint their president, for a period of three years, from amongst themselves. It is available at 'http://curia.europa.eu/en/instit/presentationfr/index_tpi.htm', (accessed on 28.08.2007).

Company taxation in the EU predicates a great diversity causing several distortions with respect to cross-border activities within the EU[127]. Decisions of investors with respect to the location of an investment, the type of investment and its source of finance are influenced from the differences between the systems of company taxation. Therefore, the fundamental economic goals of the EC Treaty are violated from these distortions.

Following the European Commission proposals, originated from the studies in the late 1960s, the Merger Directive 90/434/EEC[128], the Parent-Subsidiary Directive 90/435/EEC[129] and the Arbitration Convention 90/436/EEC[130] were finally adopted in July 1990. On 23 April 2004, the European Commission adopted a Communication[131] on a proposal for a 'Code of Conduct' for the effective implementation of the EU Arbitration Convention 90/436/EEC. The Code of Conduct requires member states to refrain from introducing any new harmful tax measures. The Code of Conduct is not a legally binding instrument but it clearly does have political force. The Code of Conduct is a political commitment and does not

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[127] Eurochambres, (2005), 'Company Taxation', Eurochambres Position Paper, Brussels, p.2., is available at 'http://www.eurochambres.eu/PDF/pdf_finance/PP%20Company %20taxation %20%20 2005.pdf', (accessed on 19.09.2007).

[128] Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, Official Journal L 225 , 20/08/1990, p.1-5, is available at 'http://eur-lex.europa.eu/LexUriServ', (accessed on 25.08.2007). This Directive is amended in 2005 by Council Directive 2005/19/EC of 17 February 2005.

[129] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states, OJ L 225, 22.9.1990, p. 6, is available at 'http://eur-lex.europa.eu/LexUriServ/site/en/consleg/1990/', (accessed on 25.08.2007). This Directive is amended in 2003 by Council Directive 2003/123/EC of 22 December 2003.

[130] Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, 90/436/EEC, OJ L 225, 20.8.1990, p.10–24, is available at 'http://eur-lex.europa.eu/LexUriServ/LexUriServ', (accessed on 25.08.2007).

[131] Communication From the Commission on the work of the EU Joint Transfer Pricing Forum in the field of business taxation from October 2002 to December 2003 and on a proposal for a Code of Conduct for the effective implementation of the Arbitration Convention, 23.04.2004, COM(2004) 97, is available at 'http://ec.europa.eu/prelex/detail_dossier_real.cfm?CL=en&DosId=190613', (accessed on 25.08.2007).

affect the rights and obligations of member states. So, it can be stated that it is a soft law instrument.

In order to reduce or eliminate these distortions, the European Commission has suggested introducing a Common Consolidated Corporate Tax Base (CCCTB) for the EU-wide activities of multinationals. As a recent development, on 2 May 2007 the European Commission adopted a Communication on implementing the Community Programme for improved growth and employment and the enhanced competitiveness of EU business: Further Progress during 2006 and next steps towards a proposal on the CCCTB[132]. The main objectives of studies on the CCCTB are such as defining a common consolidated tax base for companies operating in the EU, discussing the basic tax principles and the fundamental structural elements of a common consolidated tax base.

3.2.2. Harmonization of Indirect Taxes

'The necessity of harmonizing indirect taxes within the EU does not arise from any desire to improve the efficiency of the tax system but rather as a vital stage on the path to abolishing economic frontiers'[133]. The differences between the indirect tax systems within the EU mean that tax harmonization has implications for both government finances and the distribution of income within each member state. Up to now, indirect taxation policies directed towards avoiding distortions on free movement of capital, goods and services rely on two main harmonization areas – value added taxes and excise duties. Value added tax, the most important indirect tax, will be studied in a separate chapter in the context of European Union legislation

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[132] Communication on 'Implementing the Community Programme for improved growth and employment and the enhanced competitiveness of EU business: Further Progress during 2006 and next steps towards a proposal on the CCCTB, Brussels, 2.5.2007, COM(2007) 223, is available at 'http://ec.europa.eu/taxation_customs/resources/documents/common/whats_new/COM(2007)223_en.pdf', (accessed on 25.08.2007).

[133] John D. Fitz Gerald, (1992), 'The Distortionary Effects of Taxes on Trade in Border Areas: The Republic of Ireland- UK Border', *Tax Harmonization and Financial Liberalization in Europe*, St.Martin's Press, p.39.

due to the fact that the VAT forms the main issue of this thesis. Furthermore, while there exists a crucial amount of legislation concerning excise duties on alcoholic beverages, manufactured tobacco products and energy products, there are also some improvements on the issue of harmonization of taxation on motor vehicles mainly after the establishment of the internal market on 1 January 1993. Harmonization of taxation on motor vehicles will be studied under two titles; taxation of heavy goods vehicles and taxation on passenger cars. Finally, there remains one harmonization field in the area of indirect taxes, taxes on raising capital.

3.2.2.1. Harmonization of Excise Duties

Excise duties are considered among the most important indirect taxes on consumption. They are levied on certain products. In contrast to VAT, they are mainly specific taxes, expressed as a monetary amount per quantity of the product. The most common products on which excise duties applied are: alcoholic beverages, tobacco products and energy products (such as petroleum and gasoline). These three product categories are also those on which all EU member states apply excise duties. EU legislation in the field of excise duties was mainly adopted in the context of the establishment of the internal market on 1 January 1993. Briefly, this legislation includes three main categories; the structure of the tax to be applied to a particular group of products, the minimum rates of duty that member states have to respect for each type of product and general provisions that apply across the product categories. The most important directives in the area of alcoholic beverages are Council Directive 92/83/EEC[134] on the harmonisation of the structures of excise duties on alcohol and alcoholic beverages and Council Directive 92/84/EEC[135] on the

[134] Council Directive 92/83/EEC of 19 October 1992 on the harmonization of the structures of excise duties on alcohol and alcoholic beverages, OJ L 316, 31.10.1992, p. 21, is available at 'http://eur-lex.europa.eu/LexUriServ/site/en/consleg/1992/L/01992L0083-20040501-en.pdf', (accessed on 27.08.2007).

[135] Council Directive 92/84/EEC of 19 October 1992 on the approximation of the rates of excise duty on alcohol and alcoholic beverages, OJ L 316, 31.10.1992, p.29-31, is available at 'http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31992L0084:en:HTML', (accessed on 27.08.2007).

approximation of the rates of excise duty on alcohol and alcoholic beverages. In the field of tobacco products, Council Directive 92/79/EEC[136] on approximation of taxes on cigarettes, Council Directive 92/80/EEC[137] on approximation of taxes on manufactured tobacco other than cigarettes and Council Directive 95/59/EEC[138] on taxes other than turnover taxes which affect the consumption of manufactured tobacco are the main directives regulating this area. Basic EU legislation concerning energy products taxation are Council Directive 2003/96/EC[139] restructuring the EU framework for the taxation of energy products and electricity and Council Directive 95/60/EC[140] on fiscal marking of gas oils and kerosene.

3.2.2.2. Harmonization of Taxes on Motor Vehicles

Arrangements directed towards the harmonization of taxation on motor vehicles are mainly in two fields: heavy goods vehicles and passenger cars.

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[136] Council Directive 92/79/EEC of 19 October 1992 on the approximation of taxes on cigarettes, OJ L 316, 31.10.1992, p. 8-9, 'is available at 'http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31992L0079:en:HTML', (accessed on 27.08.2007).

[137] Council Directive 92/80/EEC of 19 October 1992 on the approximation of taxes on manufactured tobacco other than cigarettes, OJ L 316 , 31.10.1992, p.10-11, is available at 'http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31992L0080:en:HTML', (accessed on 28.08.2007).

[138] Council Directive 95/59/EC of 27 November 1995 on taxes other than turnover taxes which affect the consumption of manufactured tobacco, OJ L 291, 06.12.1995,p.40-45, is available at 'http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31995L0059:en:HTML', (accessed on 27.08.2007).

[139] Council Directive 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity, OJ L 283, 31.10.2003, p. 51–70, is available at 'http://www.managenergy.net/products/R538.htm', (accessed on 28.07.2007).

[140] Council Directive 95/60/EC of 27 November 1995 on fiscal marking of gas oils and kerosene OJ L 291, 06.12.1995, p.46-47, is available at 'http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31995L0060:EN:HTML', (accessed on 27.08.2007).

Taxation of Heavy Goods Vehicles

Another area of harmonization on indirect taxation is about the taxation of heavy goods vehicles. In this field the first legislation study is Council Directive 93/89/EEC[141] of 25 October 1993 on the application by member states of taxes on certain vehicles used for the carriage of goods by road and tolls and charges for the use of certain infrastructures. Then, Directive 1999/62/EC[142] of the European Parliament and of the Council of 17 June 1999 on the charging of heavy goods vehicles for the use of certain infrastructures replaces Directive 93/89/EEC. This Directive is also called as 'Eurovignette' Directive. It harmonises levy systems, such as vehicle taxes, tolls and charges relating to the use of road infrastructure, and establishes fair mechanisms for charging infrastructure costs to hauliers. With this Directive it is stated that member states may not set vehicle tax rates any lower than the minimum rates set out in the Directive. Under the Directive, member states also have the option, in certain cases and subject to certain conditions, of applying reduced rates or granting exemptions. The last improvement in this area is Directive 2006/38/EC[143]. It makes some amendments with a view to establishing a new Union framework for charging for the use of road infrastructure. This new arrangement also makes it possible to improve the efficiency of the road transport system in order to ensure the proper functioning of the internal market. This Directive lays down rules for the application by member states of tolls or user charges on roads, including roads on the trans-European road network and roads in mountainous regions.

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[141] Council Directive 93/89/EEC of 25 October 1993 on the application by member states of taxes on certain vehicles used for the carriage of goods by road and tolls and charges for the use of certain infrastructures, OJ L 279, 12.11.1993, p. 32–38, is available at 'http://eur-lex.europa.eu/smartapi/cgi', (accessed on 25.08.2007).

[142] Council Directive 1999/62/EC of the European Parliament and of the Council of 17 June 1999 on the charging of heavy goods vehicles for the use of certain infrastructures, OJ L 187, 20.7.1999, p. 42–50, is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga', (accessed on 25.08.2007).

[143] Council Directive 2006/38/EC of the European Parliament and of the Council of 17 May 2006 amending Directive 1999/62/EC on the charging of heavy goods vehicles for the use of certain infrastructures, OJ L 157, 9.6.2006, p. 8–23, is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc', (accessed on 25.08.2007).

Taxation on Passenger Cars

In this area, there is only one proposal for a Council Directive of 5 July 2005 on passenger car related taxes[144]. This proposal provides restructuring passenger car related taxation systems of member states with a view to improving the functioning of the internal market. It aims to remove the tax obstacles to permanently transferring passenger cars from one member state to another. The Commission proposes some measures with this proposal, such as phasing out car registration taxes (RT) over a transitional period of five to ten years, establishing a system for reimbursing registration taxes for passenger cars registered in one member state and then exported or permanently transferred to another member state, introducing an element linked to CO_2 emissions into the taxable amount of annual circulation tax (ACT) and registration taxes. The proposed structure approximates the systems for taxing passenger cars applied by the member states but does not harmonise taxation levels in member states. Proposed measures also aims to promote environmental sustainability in terms of carbon dioxide emissions by restructuring the basis on which passenger cars are taxed.

3.2.2.3. Harmonization of Taxes on Raising Capital

In order to reduce discrimination, double taxation and barriers to the free movement of capital; the issue of harmonization of the laws relating to duty chargeable on contributions of capital to capital companies and to stamp duty on securities representing capital, shares and bonds came to the European agenda, first, in 1969.

In the field of indirect taxes on raising capital, the first legislation adopted is Council Directive 69/335/EEC of 17 July 1969[145] relating to the approximation of the laws of

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[144] Proposal for a Council Directive on passenger car related taxes, 5.7.2005, COM(2005) 261, Brussels, is available at 'http://eur-lex.europa.eu/smartapi/cgi/', (accessed on 25.08.2007).

[145] Council Directive 69/335/EEC of 17 July 1969 concerning indirect taxes on the raising of capital Official Journal L 249, 03.10.1969, p.25-29, is available at 'http://eur-lex.europa.eu/LexUriServ/LexUriServ', (accessed on 25.08.2007).

the member states concerning indirect taxes on the raising of capital. While the Directives 74/553/EEC[146], 85/303/EEC[147] and 2006/98/EC amend the Directive 69/335/EC, the main aim of all of these Directives is to harmonize the taxes on the raising of capital with regard to their structures and rates; to abolish all other similar taxes on the raising of capital; and to determine the transactions which are taxable, the rate of the duty which may not be exceeding 1% and conditions of exemptions. The last development in this field is a proposal for a Council Directive of 4 December 2006[148] concerning indirect taxes on the raising of capital. This proposal relates to a recasting of Council Directive 69/335/EEC1. The purpose of the proposal is to simplify a very complicated piece of European tax legislation in the area of harmonization of taxation of capital raising; regulate capital duty which is recognised as a significant obstacle to the development of EU companies; and reinforce the prohibition on creating or levying of other similar taxes.

[146] Council Directive 74/553/EEC of 7 November 1974 amending Article 5 (2) of Directive No 69/335/EEC concerning direct taxes on the raising of capital, OJ L 303, 13.11.1974, p. 9–9 is available at 'http://eur-lex.europa.eu/smartapi', (accessed on 25.08.2007).

[147] Council Directive 2006/98/EC of 20 November 2006 adapting certain Directives in the field of taxation, by reason of the accession of Bulgaria and Romania, OJ L 363, 20.12.2006, p. 129–136, is available at 'http://eur-lex.europa.eu/smartapi/cgi/', (accessed on 25.08.2007).

[148] Proposal for a Council Directive concerning indirect taxes on the raising of capital, COM (2006) 760 final (04.12.2006), Brussels.

CHAPTER IV
EUROPEAN UNION VALUE ADDED TAX SYSTEM

As it is stated in the EC Treaty, a high degree of harmonization of indirect taxes is necessary. The proper functioning of the internal market requires VAT and excise systems that are efficient and fully reflecting the needs of EU businesses and consumers. Differences between tax systems and tax rates of the member states of the EU are the most important obstacles to realize the common market. Because of the fact that among all taxes, indirect taxes affect the single market directly, the European Union policy intends on tax coordination and harmonization focuses on the value-added taxes – the main part of the indirect tax system.

4.1. General Legal Framework of Value Added Tax in the European Union

In the VAT field, the studies have been continuing intensively for a long time to improve the VAT systems which are necessary to be adapted fully to the needs of the internal market.

The First Directive[149] and the Second Directive[150] of 11 April 1967 required member states to introduce by 1 January 1972, a common system of VAT to replace national turnover tax systems. According to the First Directive (Article 2) 'The principle of the common system of value added tax involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and

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[149] First Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes (OJ 71, 14.4.1967, p. 1301–1303) is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&lg=EN&numdoc=319 67L0227', (accessed on 10.05.2007). The First Council Directive was amended in 1969 by the Council Directive 69/463/EEC (9.12.1969) and in 1977 by the Council Directive 77/388/EEC (17.5.1977).

[150] Second Council Directive 67/228/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes - Structure and procedures for application of the common system of value added tax (OJ 71, 14.4.1967, p. 1303–1312), is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=Directiv e&an_doc=1967&nu_doc=228', (accessed on 10.05.2007).

services, whatever the number of transactions which take place in the production and distribution process before the stage at which tax is charged. On each transaction, value added tax, is calculated on the price of the goods or services at the rate applicable to such goods or services, and shall be chargeable after deduction of the amount of value added tax borne directly by the various cost components. The common system of value added tax shall be applied up to and including the retail trade stage (Article 2 of the First Council Directive 67/227/EEC). In respect of that model, the tax applies at all commercial stages from production to retail and to all categories of goods and services[151]. Although VAT is a tax on consumer expenditures, it is collected by traders. Traders add it to the selling price of their goods or services. Multiple taxation is avoided by allowing traders to deduct the VAT, which they themselves have been charged by their suppliers, from the VAT which they collect from customers[152]. The aim of this mechanism is to provide that the VAT burden on goods or services at any given moment is always equal to the VAT charged by the last supplier, regardless of the number of commercial stages involved in the production and distribution process. Tax is borne only by the final consumer who has no right of deduction. At this point, it should be stated that the common system is to be based on the neutrality principle. The main aim of the common system of VAT shows itself 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. In this context, the common system of VAT should result in neutrality even if rates and exemptions are not fully harmonized.

However, it should be asserted that the first two VAT Directives laid down only the general principles of the system and left the member states to determine the details of the VAT structure.

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[151] P. Farmer and R. Lyal, (1994), p.85.

[152] P. Farmer and R. Lyal, (1994), p.85.

VAT was chosen by the Community legislature because it was less likely to 'distort conditions of competition or hinder the free movement of goods and services within the common market'[153].

The main impetus for further harmonization, in the form of the Sixth Directive of 17 May 1977[154], come from the Council Decision of 21 April 1970[155] to finance the Community budget from the Communities' own resources since 1975[156]. Article 4 of this decision provided that one of the own resources should be VAT. In this sense, the VAT illustrates a feature of 'European tax' with its harmonized system[157]. So, it can be clearly said that VAT has a crucial impact on the process of the EU's financial autonomy. It was also recognized that a greater degree of harmonization would serve to enhance the neutrality of the tax in both domestic and intra-Community trade[158].

The Sixth Directive, which can be stated as the constitution of the EU VAT system, was to be implemented by 1 January 1978. It adopted the basic concepts and established common rules in the area of VAT.

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[153] 2nd recital in the preamble of the First VAT Directive.

[154] Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment, OJ L 145, 13.6.1977, p. 1–40, is available at 'http://eur-lex.europa.eu/LexUriServ /LexUriServ.do?uri=CELEX:32004L0015:en:HTML', (accessed on 23.04.2004).

[155] Council Decision 70/243/ECSC, EEC, Euratom: Council Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources, OJ L 94, 28.4.1970, p. 19–22, is available at 'http://eur-lex.europa.eu/LexUriServ/LexUriServ.do', (accessed on 20.05.2007).

[156] P. Farmer and R. Lyal, (1994), p.86.

[157] Nami Çağan, (1991), p.67.

[158] 3rd and 4th recitals in the preamble of the 70/243/ECSC, EEC, Euratom: Council Decision of 21 April 1970.

The Eight Directive of 6 December 1979[159] introduced arrangements for the refund of VAT. Similar arrangements concerning VAT refund for the traders out of the Union were introduced by the Thirteenth Directive of 17 November 1986[160].

The Sixth Directive was based on the 'destination based' system, which implies that VAT is effectively charged at the rate of VAT applicable where the buyer is established. But after then, the Commission stated that fiscal frontiers within the Union are incompatible with the single market with White Paper of 29 June 1985[161]. It proposed the abolition of fiscal frontiers in 1987. For this reason, the Commission proposed moving from 'destination based' principle to 'origin based' system. This system means that VAT is charged at the rate in force where the supplier is established and goods and services would be taxed in their country of origin. But at the end the Council decided to retain the destination system for a 'transitional period'. For transactions between taxable persons, the transitional arrangements introduce taxation in the country of consumption -destination system. But for retail sales to individuals the transitional arrangements require taxation in the country of origin. In this sense the transitional system is an origin based system; an individual from one member state purchasing goods in another state, pays tax in the state of purchase and imports the goods freely into his/her consumption state.

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[159] Eighth Council Directive 79/1072/EEC of 6 December 1979 on the harmonization of the laws of the Member States relating to turnover taxes - Arrangements for the refund of value added tax to taxable persons not established in the territory of the country, (Official Journal L 331, 27.12.1979), p. 11-19, is available at 'http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31979L1072:EN:HTML, (accessed on 23.08.2007).

[160] Thirteenth Council Directive 86/560/EEC of 17 November 1986 on the harmonization of the laws of the Member States relating to turnover taxes - Arrangements for the refund of value added tax to taxable persons not established in Community territory, (Official Journal L 326, 21.11.1986, p. 40 – 41), is available at 'http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31986L0560:EN:HTML', (accessed on 23.08.2007).

[161] White Paper from the Commission to the European Council, COM (85) 310 final, Brussels, 14 June 1985, available at 'http://aei.pitt.edu/1113/01/internal_market_wp_COM_85_310.pdf', (accessed on 23.08.2007).

With the Eighteenth Directive of 18 July 1989[162], many of the derogations about domestic exemptions were abolished.

Some measure of agreement was reached on the issue of approximation of tax rates by Directive 92/77[163], which laid down a minimum rate to be applied until the provisional end of the transitional period on 31 December 1996.

The 6th Directive has been amended many times since then. Most recent important amendments are the following:

Council Directive 2000/65/EC[164] amends Directive 77/388/EEC as regards the determination of the person liable for payment of VAT. The reason of this amendment was the fact that the rules for determining the person liable for payment of VAT were a problem for small operators active in several member states. In order to simplify, modernise and harmonise the conditions laid down for invoicing in respect of value added tax, the Council Directive 2001/115/EC[165] amends Directive 77/388/EEC in 2001. Then, in order to extend for two years the authorisation to

[162] Eighteenth Council Directive 89/465/EEC of 18 July 1989 on the harmonization of the laws of the Member States relating to turnover taxes - Abolition of certain derogations provided for in Article 28 (3) of the Sixth Directive, 77/388/EEC, (OJ L 226, 3.8.1989), p. 21–22, is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&type_doc=Directive&an_doc=1989&nu_doc=465&lg=en', (accessed on 23.08.2007).

[163] Council Directive 92/77/EEC of 19 October 1992 supplementing the common system of value added tax and amending Directive 77/388/EEC (approximation of VAT rates), OJ L 316, (31.10.1992), p. 1–4, is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=Directive&an_doc=1992&nu_doc=77', (accessed on 23.08.2007).

[164] Council Directive 2000/65/EC of 17 October 2000 amending Directive 77/388/EEC as regards the determination of the person liable for payment of value added tax
OJ L 269, 21.10.2000, p. 44–46 , available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=Directive&an_doc=2000&nu_doc=65', (accessed on 23.08.20007).

[165] Council Directive 2001/115/EC of 20 December 2001 amending Directive 77/388/EEC with a view to simplifying, modernising and harmonising the conditions laid down for invoicing in respect of value added tax, (OJ L 15, 17.1.2002), p. 24–28. is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=Directive&an_doc=2001&nu_doc=115', (accessed on 23.08.2007).

apply a reduced rate of VAT to labour-intensive services, the Council Directive 2004/15/EC[166] amends Article 289(6) of the Sixth VAT Directive in 2004. Next year, the Council aims to extend the period of application of the minimum standard rate of VAT (i.e. 15%) for the five years from 1 January 2006 to 31 December 2010 with the Council Directive 2005/92/EC[167]. A year later, the Council Directive 2006/69/EC[168] amended the Sixth VAT Directive to provide member states with the option of quickly adopting legally sound measures in order to counter avoidance and evasion in certain specific and targeted areas.

Lastly, Council Directive 2006/112/EC[169] of 28 November 2006 (the VAT Directive) was adopted on the common system of value added tax. This VAT Directive is a recasting of the Sixth Directive 77/388/EEC on the common system of value added tax and the uniform basis for assessment which has been amended more than thirty times since it was adopted. It codifies the provisions of Directive 77/388/EEC from 1 January 2007 without altering the substance of the legislation in force. So, in this thesis the main focus on the issue of the EU VAT system will be given to the Council Directive 2006/112/EC.

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[166] Council Directive 2004/15/EC of 10 February 2004 amending Directive 77/388/EEC to extend the facility allowing Member States to apply reduced rates of VAT to certain labour-intensive services, (OJ L 52, 21.2.2004), p. 61–61, is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=Directive&an_doc=2004&nu_doc=15', (accessed on 23.08.2007).

[167] Council Directive 2005/92/EC of 12 December 2005 amending Directive 77/388/EEC with regard to the length of time during which the minimum standard rate of VAT is to be applied, (OJ L 345, 28.12.2005), p. 19–20, is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=Directive&an_doc=2005&nu_doc=92', (accessed on 23.08.2007).

[168] Council Directive 2006/69/EC of 24 July 2006 amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion or avoidance, and repealing certain Decisions granting derogations
OJ L 221, 12.8.2006, p. 9–14, is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=Directive&an_doc=2006&nu_doc=69', (accessed on 23.08.2007).

[169] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax
OJ L 347, 11.12.2006, p. 1–118, is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!DocNumber&lg=en&type_doc=Directive&an_doc=2006&nu_doc=112', (accessed on 23.08.2007).

4.2. Basic Principles of Value Added Tax System in the European Union

The VAT is broadly based consumption tax assessed on the value added to goods and services. It applies to all goods and services, except the goods which are sold for export or services which are sold to abroad. Conversely, imports are taxed, to keep the system fair for EU producers so that they can compete on equal terms on the European market with suppliers situated outside the Union[170]. The basic principles to clarify the working logic of the VAT system can be explained under five titles. First, VAT is a general tax that applies to all commercial activities from each stage of production to sales to final consumer[171]. Secondly, due to the fact that VAT is borne ultimately by the final consumer, VAT is a consumption tax. Thirdly, it is charged as a percentage of prices. Fourthly, it is collected fractionally. It is also called as deduction mechanism. Via this mechanism, taxable persons deduct the amount of tax they have paid to other taxable persons on purchases for their business activities from the VAT they have collected. Lastly, the shifting feature is the main principle of VAT. That is, VAT is paid to the authorities by the seller of the goods, who is the 'taxable person', but it is actually paid by the buyer to the seller as part of the price.

4.2.1. The Subject Matter and Scope of Value Added Tax

Taxable transactions subject to VAT are the supplies of goods by a taxable person, intra-Community acquisition of goods in a member state from another member state, the supply of services by a taxable person and importation of goods from outside the EC (from a third territory or third country) (Article 2 of the Council Directive 2006/112/EC).

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[170] European Commission, (2007),'General Overview- What is VAT?', is available at 'http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/index_en.htm', (accessed on 01.07.2007).

[171] Hitiris, (2004), p.113.

For the purposes of applying the VAT Directive, 'Community', 'territory of the Community', 'third territories' and 'third country' are defined in Article 5 of the Council Directive 2006/112/EC. In this sense, 'Community' and 'territory of the Community' mean the territories of the member states. Member state and territory of a member state mean the territory of each member state of the Community to which the EC Treaty is applicable with the exception of any territory like Mount Athos, the Canary Islands, Livigno, Mellilla, …(which are called as third territories) referred in Article 6 of the Council Directive 2006/112/EC. Lastly, 'third country' means any state or territory to which the EC Treaty is not applicable (Article 5/4 of the Council Directive 2006/112/EC).

In the field of the subject of the common VAT system, the main principle is 'territoriality principle'. It means that a member state taxes supplies, intra-Community acquisitions of good, imports from non-member countries which are made **within its territory**[172]. As a general rule, tax laws of a country are valid only within its territory, expressing the principle of application of tax laws for land and the financial frontiers of a country means its customs frontiers[173]. In the EU context, it also means that no VAT is charged on exports between the member countries and non-member countries. Of course, the VAT paid for the input is deducted. As far as imports are concerned, VAT must be paid at the moment the goods are imported.

It should be asserted that the most important issue of the common VAT system of the EU is the 'VAT on goods moving between the member states', which is directly linked with the context of 'subject of the tax'. For this purpose 'supply of goods', intra-Community acquisition of goods', 'supply of services' and 'importation of goods' terms are defined in Articles 14-30 of the Council Directive 2006/112/EC. The 'supply of goods' is the transfer of the right to dispose of tangible property as

[172] P. Farmer and R. Lyal, (1994), p.91, (Due to the fact that the Council Directive 2006/112/EC only codifies the 6th Directive and does not amend the provisions of 6th Directive, there is no objection to use this source which is predicated on the 6th Directive).

[173] M. Öncel, A. Kumrulu and N. Çağan, (2006), *Vergi Hukuku*, 14.Bası, Ankara, Turhan Kitapevi, p.57.

owner (Article 14/1 of the Council Directive 2006/112/EC). Any transaction which does not constitute a supply of goods constitutes 'supply of services' (Article 24/1 of the Council Directive 2006/112/EC). The 'intra-Community acquisition of goods' is the acquisition of the right to dispose as owner of movable tangible property transported to the person acquiring the goods in another member state (Article 20 of the Council Directive 2006/112/EC). The entry into the Community of goods which are not in free circulation is named as the 'importation of goods'. The entry of goods which are in free circulation from a third territory is also called as an importation (Article 30 of the Council Directive 2006/112/EC). These definitions are important points in terms of the comparison of the two – EU and Turkish - VAT laws.

4.2.2. Taxable Person

Taxable person is a person who carries out in any place any economic activity, independently, whatever the purpose or results of that activity (Article 9 of the Council Directive 2006/112/EC).

In this context, main focus should be given to the term 'economic activity'. The economic activity refers to any activity of producers, traders and persons supplying services including mining and agricultural activities and activities of the professions (Article 9 of the Council Directive 2006/112/EC).

The broad definition of taxable person is due to the fact that one of the main features of VAT is being a general tax on consumption. It means VAT is intended to cover any person carrying on any independent economic activity[174]. This broad definition, especially the terms of 'economic activity' is a very important point for the adaptation process of Turkey to the *acquis communautaire*. This issue will be detailed in the following chapters.

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[174] P. Farmer and R. Lyal, (1994), p.108.

Not only the Council Directive 2006/112/EC itself, but also the ECJ has given the term of 'economic activity' a broad interpretation. For example, in Case 235/85[175], Commission *v.* Netherlands the Dutch Government, it is argued that the official services performed by notaries and bailiffs in the Netherlands are not economic activities subject to VAT since they are not governed by normal economic laws but are performed in return for remuneration fixed by statue and involved services which individuals are required to use for reasons of public services[176]. But the ECJ said that the notaries and bailiffs were taxable persons in so far as they provided services to private individuals in return for remuneration.

The words '**in any place**' in Article 9/1 states that it is insignificant where the activity is carried out. That is, a person who carries on one of the activities listed in paragraph 2 of this Article is a taxable person even if he/she is established and carries on his/her activity in another member state or outside the Union.

Additionally, the term **'independently'** should be understood well, because of the fact that a separate Article is devoted to this concept. According to the Article 10 of the VAT Directive, to the extent that they are bound to their employer by a contract of employment or by any other legal ties creating the relationship of employer and employee, the activities of salaried and other persons are not regarded as being carried out 'independently'.

Article 9/1 does not require the economic activity to be '**regularly**' carried out[177]. However, it is understood from Article 9/2[178], which gives authority to tax

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[175] The European Court of Justice, Judgment of the Court of 26 March 1987. - Commission of the European Communities v Kingdom of the Netherlands -Case 235/85, (1985), is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&numdoc=61985J0235&lg=en', (accessed on 24.05.2007).

[176] P. Farmer and R. Lyal, (1994), p.108.

[177] P. Farmer and R. Lyal, (1994), p.109.

[178] Article 9(2) of the Council Directive 2006/112/EC; 'In addition to the persons referred to in paragraph 1, any person who, on an occasional basis, supplies a new means of transport, which is

‘occasional’ activities. This article provides that any person who, on an occasional basis, supplies a new means of transport which is transported to another member state is also regarded as a taxable person. So, it should be clearly asserted that considering a taxable person as the one who carries on an economic activity on a regular basis is the general rule.

As a last point, the statement ‘**whatever the purpose or results of that activity**’ indicates that it is insignificant whether the activity is carried on in terms of making a profit or will make a profit. An activity does not cease to be an economic activity merely because it is loss-making or carried on for charitable purposes[179]. For instance, a private hospital is a taxable person even if it is a non-profit-making charity.

4.2.3. Taxable Amount

As far as ‘taxable amount’ is concerned, Article 72 of the Council Directive 2006/112/EC defines the taxable amount broadly. Different from the 6th Directive, after defining the term ‘open market value’ in Article 72, the Council Directive 2006/112/EC determines the taxable amount for supply of goods or services, intra-Community acquisition of goods and for importation of goods separately.

With respect to the supply of goods or services and intra-Community acquisition of goods and services, the taxable amount includes everything which constitutes consideration obtained by the supplier for transactions from the customer. This includes subsidies directly linked to the price of these transactions (Articles 73 and 83 of the Council Directive 2006/112/EC). For the importation of goods, taxable

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dispatched or transported to the customer by the vendor or the customer, or on behalf of the vendor or the customer, to a destination outside the territory of a Member State but within the territory of the Community, shall be regarded as a taxable person.’

[179] P. Farmer and R. Lyal, (1994), p.109.

amount is determined as the value for customs purposes (Article 85 of the Council Directive 2006/112/EC).

In Article 73, the statement ‘subsidies which are directly linked to the price of supplies’ restricted the consideration. The effect of this restriction is excluding general subsidies granted without any specific reference to price from the scope of the tax[180].

Article 78 covers some detailed provisions about the factors included in taxable amount for supply of goods or services and intra-Community acquisition of goods. According to this article the taxable amount also includes taxes, duties, levies and charges, excluding the value added tax itself; and incidental expenses such as commission, packing, transport and insurance costs charged by the supplier to the customer. In this respect, expenses covered by a separate agreement may be considered to be incidental expenses by the Member States (Article 78 of the Council Directive 2006/112/EC).

Another important issue is factors that are not included in taxable amount for only supply of goods or services. According to the Article 79, price reductions by way of discount for early payment and price discounts and rebates allowed to the customer and accounted for at the time of the supply are not included in the taxable amount. Also the amounts received by a taxable person from the customer as repayment for expenditures incurred in the name and on behalf of the customer, and entered in his/her books in a suspense account are not included in taxable amount, but there is condition for this factor. The taxable person must furnish proof of the actual amount of this expenditure and may not deduct any tax which may have been charged on these transactions (Article 79 of the Council Directive 2006/112/EC).

Different form the 6th Directive, new VAT Directive determines the factors which are included and not included in taxable amount separately for the importation of

[180] P. Farmer and R. Lyal, (1994), p.126.

goods. Briefly, taxable amount includes taxes, duties, levies and other charges due outside the member state of importation, and those due by reason of the importation (excluding the VAT itself) and incidental expenses (such as packing, transport, etc.) (Article 86 of the Council Directive 2006/112/EC). According to the Article 87, the taxable amount does not include price reductions by way of discount for early payment and price discounts and rebates granted to the customer and obtained for him/her at the time of importation.

VAT as a consumption tax, taxes expenditure on goods and services. Article 2 of the Council Directive 2006/112/EC reflects that characteristic by limiting the scope of VAT to supplies of goods or services **'for consideration'.** But the VAT Directive does not define what 'consideration' means. But at this point, the ECJ laid down two criteria for the term 'consideration'. First, a direct link must exist between the service provided and the consideration received. Secondly, the consideration must be capable of being expressed in money and constitute a 'subjective' value, inasmuch as the taxable amount is the consideration actually received and not a value assessed according to objective criteria[181].

It should also be stated that the ECJ's interpretation of the concept of 'consideration' is used as the basis for determining the 'taxable amount' or 'price' in everyday language[182]. In this sense it can be easily said that the word 'consideration' in Article 2 of the VAT Directive replaces the word 'payment'.

4.2.4. Exemptions

The primary aim of the VAT Directive is to establish a uniform basis for collection of the Community's own resources. This implies a need for drawing up the common

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[181] The European Court of Justice, Judgment of the Court (Second Chamber) of 5 February 1981. - Staatssecretaris van Financiën v Association coopérative "Coöperatieve Aardappelenbewaarplaats GA". - Case 154/80, is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEX numdoc&numdoc=61980J0154&lg=en', (accessed on 10.06.2007).

[182] P. Farmer and R. Lyal, (1994), p.90.

list of exemptions so that the EU's own resources may be collected in a uniform manner in all the member states.

First Chapter of 'Title IX- Exemptions' of the Council Directive 2006/112/EC is devoted to general provisions. For all of the exemptions, member states must lay down conditions 'for purpose of ensuring the correct and straightforward application of such exemptions and of preventing any possible evasion, avoidance or abuse' (Article 131 of the Council Directive 2006/112/EC).

At the beginning, it should be noted that the systematic of the exemptions part is very different from the 6th Directive, although the content is similar. In order to simplify exemptions, they are specified chapter by chapter. There are nine different types of exemptions under this title: exemptions for certain activities in the public interest (such as hospital and medical care, goods and services linked to welfare and social security work, school and university education and certain cultural services), exemptions for other activities (such as insurance transactions, the granting of credit and certain banking services, supplies of postage stamps, lotteries and gambling and certain supplies of immovable property), exemptions for intra-community transactions, exemptions on importation, exemptions on exportation, exemptions related to international transport, exemptions relating to certain transactions treated as exports, exemptions for the supply of services by intermediaries, exemptions for transactions relating to international trade (Articles 132-165 of the Council Directive 2006/112/EC).

It should also be noted that the exemptions have consistently been interpreted narrowly by the ECJ. A narrow interpretation is justified since it serves to limit the disruption to the VAT system[183]. A case example can be given in order to clarify the subject. In Case 348/87[184], *Stichting Uitvoering Financiële Acties V Staatssecretaris*

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[183] P. Farmer and R. Lyal, (1994), p.172.

[184] The European Court of Justice, Judgment of the Court (Fourth Chamber) of 15 June 1989, 'Stichting Uitvoering Financiële Acties v Staatssecretaris van Financiën', Case 154/80, is available at

van Financiën, the Court held that the exemption referred in Article 13/a-1-f [185] (it is corresponding to Article 132/f of the Council Directive 2006/112/EC) is applicable only to independent groups of persons supplying services to their members and can not be extended to the supply of services by one foundation to another.

4.2.5. The Right of Deduction

The right of a taxable person to deduct the input VAT incurred on the goods and services used for making the supplies from the output VAT payable on his/her supplies is in the core of the VAT logic. So, deduction of the VAT is one of the most important issues in the area of the EU VAT system.

The provisions concerning the right of deduction are contained in Articles 167 to 193 of the Council Directive 2006/112/EC.

According to the Article 167/1, deduction right arises at the time when the deductible tax becomes chargeable. Under Article 168, a taxable person's right of deduction extends to VAT incurred on the two main transactions. First, a taxable person who purchases goods or services has the right to deduct the amount of the VAT in the member state where these transactions are carried out if the goods and services are used for his professional economic activity. Secondly, in respect of the importation of goods into a member state the VAT due or paid can be deducted from the VAT which taxpayer is liable to pay (Article 168 of the Council Directive 2006/112/EC).

'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!ELEXnumdoc&numdoc =61987J0348&lg=en', (accessed on 10.06.2007).

[185] 'Services supplied by independent groups of persons whose activities are exempt from or are not subject to value added tax, for the purpose of rendering their members the services directly necessary for the exercise of their activity, where these groups merely claim from their members exact reimbursement of their share of the joint expenses, provided that such exemption is not likely to produce distortion of competition' (Article 13/A-1-f of 6th Directive).

On the other hand, a taxable person who pays VAT in a member state where he is not established may secure reimbursement through a special procedure (Articles 173-176 of the Council Directive 2006/112/EC).

In certain cases deductions may be limited or adjusted. They require certain conditions to be fulfilled, particularly the obligation to hold an invoice (Article 178 of the Council Directive 2006/112/EC).

Under subparagraph (a) of Article 168, a taxable person is entitled to deduct VAT only on supplies made to him/her[186]. That is to say, a third one (a person other than the recipient of the supply) making the payment (consideration) for a supply under Article 168/a is not entitled to deduct the VAT charged.

Under Article 168, a taxable person has the right to deduct VAT on goods and services only '*in so far as they are used for the purposes of the taxed transaction of a taxable person*.' In principle therefore he/she is not entitled to deduct VAT on goods and services used for transactions that are exempt or are outside the scope of the tax of a member state[187].

Article 176 is related to expenditures not qualifying for deduction. It says that VAT shall in no circumstances be deductible on expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainment.

Article 178 of the VAT Directive determines the rules governing exercise of the right of deduction. Article 178/1 lays down the conditions which must be met by a taxable person in order to exercise the right of deduction. Article 179 provides that a taxable person is to affect deduction of tax by subtracting from the total amount of VAT due for a given period the total amount of tax in respect of which the right of deduction has arisen during the same period. It identifies the principle of immediate deduction.

[186] P. Farmer and R. Lyal, (1994), p.191.

[187] P. Farmer and R. Lyal, (1994), p.191.

> Where for a given tax period, the input VAT deductible exceeds the output tax due, member states may make a refund or carry the excess forward to the following period. A refund or carry-forward may however be refused if the amount of the excess is significant. (Article 183 of the Council Directive 2006/112/EC)

As far as refunds are concerned, taxable persons who incur VAT in connection with their business activities in a member state in which they do not make supplies of goods or services are entitled to deduct the VAT charged in that member state. This 'deduction' is by means of a refund of VAT from the member state in which the VAT was paid. On this issue, Article 171 of the Council Directive 2006/112/EC states that;

> VAT shall be refunded to taxable persons who are not established in the member state in which they purchase goods and services or import goods subject to VAT but who are established in another member state, in accordance with the detailed implementing rules laid down in Directive 79/1072/EEC[188]. (Article 171 of the Council Directive 2006/112/EC)

Article 3 of the Directive 79/1072/EEC determines the conditions of VAT refund. According to this article, to qualify for refund, any taxable person who is not established in the territory of the country but who is established in another member state should:

a) submit to the competent authority an application modelled on the specimen, attaching originals of invoices or import documents. (The application shall be drawn up on a form printed in one of the official languages of the European Communities. This form shall, however, be completed in the language of the country of refund. The application shall be completed in block capitals and be submitted, by 30 June of the year following that to which the application relates, to the competent authority of the State to which the application is made. The VAT registration number in the country of refund shall be given. The application shall be submitted to the relevant competent

[188] Eighth Council Directive 79/1072/EEC of 6 December 1979 on the harmonization of the laws of the Member States relating to turnover taxes - Arrangements for the refund of value added tax to taxable persons not established in the territory of the country, OJ L 331, 27.12.1979, p. 11–19.

authorities The application shall refer to purchases of goods or services invoiced or to imports made during a period of not less than three months or more than one calendar year. The applicant shall describe the nature of the activities for which he has acquired the goods or received the services referred to in the application for refund of the tax).

b) produce evidence, in the form of a certificate issued by the official authority of the state in which he is established, that he is a taxable person for the purposes of value added tax in that state. However, where the competent authority has already such evidence in its possession, the taxable person shall not be bound to produce new evidence for a period of one year from the date of issue of the first certificate by the official authority of the state in which he is established.

c) undertake to repay any sum collected in error.

In this sense, it can be stated that in the EU context, there are many conditions for VAT refunds, as well as in Turkey.

4.2.6. Chargeable Event

Articles 62-72 of the Council Directive 2006/112/EC lays down the provisions related to the chargeable event and the moment when the tax becomes chargeable.

'Chargeable event' is defined as 'the occurrence by virtue of which the legal conditions necessary for tax to become chargeable are fulfilled' in Article 62/1 of the Council Directive 2006/112/EC.

According to Article 62/2 of the Council Directive 2006/112/EC, the tax becomes 'chargeable' when the tax authority becomes entitled under the law at a given moment to claim the tax from the person liable to pay, notwithstanding that the time of payment may be deferred.

There are two important issues at this point. First, the chargeable event determines the rate of tax applicable to a transaction. Secondly, the right to deduct tax charged on a transaction arises at the time when the deductible tax becomes chargeable.

However, the Council Directive 2006/112/EC is different from the 6th Directive on the issue of determining chargeable event for supply of goods or services, intra-community acquisition of goods and for importation of goods separately.

In principle the chargeable event occurs and the tax becomes chargeable at the same time, namely when the goods or the services supplied, as it is stated in Article 63 of the VAT Directive. Additionally, member states may in certain cases provide that continuous supplies of goods or services which take place over a period of time is to be regarded as being completed at least at intervals of one year (Article 64/2 of the Council Directive 2006/112/EC).

The chargeable event occurs when the acquisition is made in the case of intra-Community acquisition of goods (Article 68 of the Council Directive 2006/112/EC). The VAT becomes chargeable on the 15th day of the month following the acquisition. However, if an invoice is issued before the 15th day of the month following that in which the chargeable event occurs, the tax becomes chargeable on the date the invoice is issued (Article 69 of the Council Directive 2006/112/EC).

In the case of importation of goods, the chargeable event occurs and VAT becomes chargeable when the goods are imported (Article 70 of the Council Directive 2006/112/EC).

4.2.7. Rates

If distortions are to be avoided, the abolition of fiscal controls at frontiers entails, not only a uniform basis of assessment, but also sufficient alignment as between member states of a number of rates and rate levels[189].

The issue of VAT rates is primarily regulated in Article 12 of the 6th Directive. The VAT Directive 2006/112/EC of 28 November 2006 (Official Journal L 347, 11.12.2006, p.1) provides in its Articles 93 to 130 and Annex III and IV a legal framework for the application of VAT rates in member states. Member states have made and continued to make wide use of the possibilities offered within this framework. As a result, the situation is in practice disparate and complex[190].

There are three basic rules in the field of rates:
1) From 1 January 2006 until 31 December 2010, the standard rate may not be less than 15% (Article 97 of the Council Directive 2006/112/EC),
2) Member states may apply one or two reduced rates of not less than 5% to goods and services enumerated in a restricted list (applied only to supplies of the categories of goods and services specified in Annex III) (Articles 98-101 of the Council Directive 2006/112/EC),
3) Member states may also, under certain conditions, apply a reduced rate to certain labour intensive service.

Consequently, it can be said that the new VAT Directive (2006/112/EC) does not have so much different provisions on subject matter and scope of VAT, taxable person, taxable amount, exemptions, right of deduction, chargeable event and rates when comparing it with the 6th Directive. In order to ensure that the provisions are presented in a clear and rational manner, this new VAT Directive recasts the

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[189] 28 Recital in the preamble of the Council Directive 2006/112/EC.

[190] European Commission, (2007), 'VAT Rates', is available at 'http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/rates/index_en.htm', (accessed on 07.08.2007).

structure and the wording of the 6th Directive. In principle, this recasting does not bring about material changes in the existing legislation. But, a small number of amendments are inherent.

On the other hand, it can be clearly stressed that the objective of establishing an internal market through out the application in member states of legislation on turnover taxes that does not distort conditions of competition or hinder the free movement of goods and services is still preserved with this new VAT Directive. It is still adopted with this new VAT Directive that it is therefore necessary to achieve such harmonisation of legislation on turnover taxes by means of a system of value added tax which achieves the highest degree of simplicity and of neutrality when the tax is levied in as general a manner as possible and when its scope covers all stages of production and distribution, as well as the supply of services[191].

Lastly, it should be noted that, in the context of European Union, even if rates and exemptions are not fully harmonised, the common system of VAT is expected to be resulted 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[192].

Consequently, it can be expressed that the indirect taxation acquis of the EU consists of harmonised legislation, especially in the field of VAT and excise duties. VAT was first introduced in the European Union in 1967, with the Sixth VAT Directive from 1977 which was codified in 2006 by the Council Directive 2006/112/EC. It includes the application of a non-cumulative general tax on consumption. It covers all stages of production and distribution of goods and services. The VAT acquis provides for an equal tax treatment of domestic and import transactions. VAT is also based on the neutrality principle whereby the tax applied is proportional to the price, whatever the number of intermediate transactions.

[191] 5 Recital in the preamble of the Council Directive 2006/112/EC.

[192] 7 Recital in the preamble of the Council Directive 2006/112/EC.

CHAPTER V
TURKISH VALUE ADDED TAX SYSTEM

5.1. General Legal Framework of Value Added Tax in Turkey

From an economic point of view, the Turkish tax system can be divided into four main categories, in terms of budgetary classification:

1) Taxes on Income

a) Personal Income Tax Law, No:193 (OG No.10700, dated 06.01.1961)
b) Corporate Income Tax Law, No:5520 (OG No.26205, dated 21.06.2006)

2) Taxes on Consumption

a) Value Added Tax Law, No: 3065 (OG No. 18563, dated 02.11.1984)
b) Excise Duty Law, No:4760 (OG No. 24783, dated 12.06.2002)
c) Law No: 6802 (OG No.9362, dated 23.07.1956)
   - Banking and Insurance Transaction Tax (Art.28)
   - Special Communication Tax (Art.39)
   - Lotteries Tax (Art.40)
d) Stamp Duty Law, No:488 (OG No.11751, dated 11.07.1964)
e) Valuable Papers Tax Law, No:210 (OG No.11343, dated 28.02.1963)
f) Law on Fees, No:492 (OG No. 11756, dated 17.07.1964)

3) Taxes on Wealth

a) Motor Vehicle Tax Law, No.197 (OG No.11342, dated 23.02.1963)
b) Inheritance and Gift Tax Law, No.7338 (OG No. 10231, dated 15.06.1959)

4) Local Taxes

a) Property Tax Law, No.1319 (OG No. 13576, dated 11.08.1970)
b) Law on Municipality Revenues, No.2464 (OG No.17354, dated 29.05.1981)
   - Local taxes other than Property Tax
   - Local fees, Participation shares

In Turkey, there are two main indirect taxes. One of them is value added tax (VAT), and the other one is excise duty.

The VAT Law, No. 3065[193] was put into force on 1 January 1985. While the studies on the legislative process are going on, the 6th VAT Directive of the European Union is used as the main source[194]. Although Turkey is not a member state, a spontaneous harmonization process was chosen at the beginning. By the introduction of VAT Law eight consumption taxes were abolished. Domestic production tax, production tax on imports, postal services tax and transportation tax were to name some of these taxes.

It can be clearly said that in terms of revenues the most important indirect tax in Turkey is VAT. In 2006, the total VAT revenue is 41.336.800.000- NTL which is 30.0 % of the total tax revenues. While the amount of 15.911.290.000-NTL is domestic VAT, 25.425.510.000-NTL is VAT on importation. Comparing the shares of personal income tax (21%) and corporate income tax (8.1%) with that of VAT, in total tax revenues, it can be seen that even their sum (29.1%) is lower than that of VAT[195]. Taking into consideration that the total revenues is 173.483.430.000-NTL in 2006, VAT is composed of 23.8 % of the total revenues.

On the other hand, excise duties have an important share in total tax revenues. In 2006, the total excise duty revenue is 36.926.175.000-NTL which is 26% of the total tax revenues[196]. It is the second biggest share in total tax revenues as well as total revenues, following VAT.

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[193] Katma Değer Vergisi Kanunu, No.3065, OG. No. 18565, dated 02.11.1984, is available at ‘http://www.gib.gov.tr/index.php?id=1028’, (accessed on 23.08.2007).

[194] Nurettin Bilici, (2004), p.159.

[195] The amounts are available at ‘http://www.muhasebat.gov.tr/mbulten/T10-12-2.xls’, (accessed on 20.07.2007).

[196] The amounts are available at ‘http://www.muhasebat.gov.tr/mbulten/T10-12-2.xls’, (accessed on 20.07.2007).

The other indirect taxes in Turkish tax system are Banking and Insurance Transaction Tax, Special Communication Tax and Lotteries Tax. The total amount of these three indirect taxes is 6.570.747.000-NTL in 2006 and constitutes a little part of the total tax revenues (4.7%).

However, it should also be expressed that the share of VAT has increased since 1985, taking into account that the share of VAT in total tax revenues was 24.8% in 1985. This share increased to 33.0% in 1994. Now, in 2007, this share is 30.0%, excluding the tax rebates from VAT revenues. If the tax rebates is included, the total VAT revenues reaches the amount of 50.723.547.000-NTL in 2006, and this amount constitutes the 33.5% of the total tax revenues. The increasing share of VAT revenues can be seen in detail in Appendix A[197].

Consequently, increasing share of VAT in Turkey should be evaluated in terms tax justice. Comparative analysis of direct and indirect tax shares in total tax revenues is used as one of the main tools for examining the equality of tax burden, due to the fact that direct taxes are adopted to be more effective to ensure the tax justice[198]. It can be stated that in direct taxes, there is a relation between the arrangements such as minimum allowance, progressive tax tariffs, deductions and exemptions and ability to pay tax. However, in indirect taxes, the tax burden is actually located on lower-income taxpayers[199]. On the other hand, while in European countries, the share of indirect taxes and direct taxes in total revenues is approximately 35% and 65%[200];

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[197] The table is available at 'http://www.gib.gov.tr/fileadmin/user_upload/VI/CVI/Tablo_47.xls.htm', (accessed on 16.09.2007).

[198] Hasan Özfidan, (2004), 'Ülkemizde Vergi Adaleti Nasıl Sağlanır?', is available at 'http://www.malihaber.com/modules.php?name=News&file=article&sid=276', (accessed on 16.09.2007).

[199] See also for a detailed analysis about 'tax justice'; Abdurrahman Akdoğan, (2006), *Kamu Maliyesi*, 11.Baskı, Gazi Kitapevi, Ankara, p.266.

[200] The rate is available at 'http://www.malihaber.com/modules.php?name=News&file=article&sid=276', (accessed on 16.09.2007).

these rates are about 68% and 32%[201] in Turkey, respectively. In this sense, it can be expressed that tax justice is more ensured in European countries, comparing the shares of direct and indirect taxes with that of Turkey.

5.2. Basic Principles of Value Added Tax System in Turkey

The Turkish tax system levies value added tax on the supply and the importation of goods and services. So, it can be said that delivery of goods and performance of services in Turkey and importation of goods to Turkey are the transactions within the scope of the VAT.

VAT is levied at each stage of the production and the distribution process. Although liability for the tax falls on the person who supplies or imports goods or services, the real burden of VAT is borne by the final consumer[202]. As mentioned in the previous chapter, this is a result of VAT's most important feature called as tax shifting. This result is achieved by a deduction mechanism. This mechanism is based on the difference between the VAT liability of a person on his/her sales (output VAT) and the amount of VAT he/she has already paid on his/her purchases (input VAT).

Generally, the Turkish VAT system has multiple rates and the Council of Ministers is authorized to change the VAT rates within certain limits. Detailed information on the rates is supplied in part 5.2.7. of this thesis.

5.2.1. The Subject Matter and Scope of Value Added Tax

In Turkish VAT Legislation the scope of the VAT is determined by the VAT Law, No.3065. The first article of this law is concerning with the scope of the VAT. It states that;

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[201] The rate is available at 'http://www.gib.gov.tr/fileadmin/user_upload/VI/GBG/Tablo_2.xls.htm', (accessed on 16.09.2007).

[202] İsmail Türk, (1999), *Kamu Maliyesi*, Ankara, 3.Bası, Turhan Kitapevi, p.137.

> Deliveries and services conducted within the framework of commercial, industrial, agricultural, self-employed activities and importation of goods and services of whatever kind are subject to Turkish VAT, provided that these transactions are affected in Turkey. (Article 1 of VAT Law, No.3065)

The deliveries and services arising from other activities are subject to VAT according to the Article 1/3 of Turkish VAT Law.

The subject of the VAT is consisted of the transactions defined in Article 1 of the VAT Law. Transactions can be determined as ‘supply of goods or services’. In this sense it can be said that the transactions not covered by the first article are not subject to VAT.

In order to speak about VAT, the following three conditions should be realized concurrently;

1) existence of the transaction such as supply of goods or services,

2) carrying out the transaction in Turkey,

3) carrying out the transaction within the scope of commercial, industrial, agricultural or professional activities (personal and casual transactions are not subject to VAT)[203].

In addition to the Article 1/1, all kinds of importation of goods and services are also covered by the Article 1/2; and in the sub-paragraph 3 of Article 1, some transactions are mentioned individually in order to be covered by VAT, such as deliveries and services arising from postal, telephone, telegraph, telex and other similar services as well as radio and television services and transportation of crude oil, gas oil and products thereof through pipelines.

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[203] M. Öncel, A. Kumrulu and N. Çağan, (2006), p.404.

5.2.2. Taxable Person

The term ‘taxable person’ is used as ‘taxpayer’ in Turkish VAT Law. Article 8 of the VAT Law is defining taxpayer. Taxpayers of the VAT are, in case of deliveries of goods or performances of services, those who carry out these works. In case of importation, taxpayer is the importer of goods and services. For transit transportation, those who are subject to customs and transit transactions are called as taxpayers. According to this Law, the Directorate General of the Post, Telephone, and Telegraph (PTT), radio and television corporations and organizers of all kinds of games of chance are deemed to be taxpayers. Lessors of the properties and rights specified in Article 70 of the Income Tax Law and the person making the request in case of voluntary tax liability are determined as taxpayers (Article 8/1 of VAT Law, No.3065).

Except for some exemptions, the main ‘taxpayer’ group is that supplying goods or services. But taxpayer of the VAT does not mean to be ‘final tax bearer’. This is also the definition of ‘tax shifting’. On the other hand, non-existence of tax shifting means that taxpayers and the final tax bearers are the same people. This is called tax incidence[204]. In these shifting taxes, taxpayers shift the tax to the consumer, by including it in the price.

5.2.3. Taxable Amount

The term ‘taxable amount’ is used as ‘taxable base’ in Turkish VAT Law. Taxable base means the amount on which the VAT rate is calculated. According to Article 20 of this law, tax base of transactions pertaining to deliveries or services is the value which constitutes the price of such transactions. In this sense, the term ‘value’ means the total money, goods, and all other benefits, services and assets represented by money in compensation for such transactions and obtained by whatever means, and

[204] İsmail Türk, (1999), p.137.

which are received from or debited by those who receive goods or benefit from services, or by those who act on their behalf (Article 20/1-2 of VAT Law, No.3065).

In the case of types of work where the price is determined based on a particular schedule, or where the value is collected by means of a ticket, the schedule and ticket price shall be calculated by including the VAT, and the tax shall not separately be passed on to the customer (Article 20/3 of VAT Law, No.3065).

In Article 20, in case of supply of goods and services, the taxable base is determined as the 'consideration' of supplying those goods or services. But in Turkish legislative terminology, the term 'value' is chosen instead of 'consideration'. It means the 'payment' excluding the VAT in consideration of supplying goods or services. In this sense, the VAT is not included in the 'value'.

In order to eliminate the taxable base/amount 'shrinking', there are some other articles related to the VAT's taxable base. One of them is Article 24. This article determines the factors that must be included in taxable base. Transportation, loading, unloading expenses made by the seller for delivery to the point specified by the recipient and costs of packaging, insurance, commission and similar expenses, and the elements such as taxes, duties, charges, shares and contribution to the fund are the factors included in taxable base. Additionally, various income such as due date difference, price differentials, interest, and premiums, as well as all benefits, services and assets provided under service and similar names are also deemed to be the factors that must be included in taxable base (Article 24 of VAT Law, No.3065).

Another important issue in the case of 'taxable base' is 'factors not included in taxable base'. Article 25 defines these elements. In deliveries and services transactions, discounts shown in invoices and similar documents made in amounts in conformity with commercial practice is one of the factors that must be included in taxable base. The other one is calculated VAT (Article 25 of VAT Law, No.3065).

In order to exclude discounts while calculating tax base, there are two conditions: the discount must be shown in invoices and similar documents and the amount of discount must be in conformity with commercial practices[205].

5.2.4. Exemptions

There are two types of exemptions in Turkish VAT system. The first one is called 'full exemptions'. They are the exemptions with right of deduction and with right of refund. The second type is called 'partial exemptions'. They do not have the right of refund. There are fifteen different full exemptions. These are summarized below;

Exportation exemption (Article 11 of VAT Law); exemption for sea, air, and railway vehicles (Article 13/a of VAT Law); exemption for services provided to sea and air transportation vehicles (Article 13/b of VAT Law); exemption for petroleum explorations (Article 13/c of VAT Law); exemption for exploring, processing, enrichment and refining activities for precious metals (Article 13/c of VAT Law); exemption for delivery of machine and equipment referred in Investment Incentive Certificates (Article 13/d of VAT Law); exemption for construction, modernization and extensions of seaports and airports (Article 13/e of VAT Law); exemption for national security expenses (Article 13/f of VAT Law); exemption for transit and international transportation (Article 14/1 of VAT Law); exemption for delivery of diesel to truck, towing vehicles, semi-trailers with refrigeration system (Article 14/3 of VAT Law); diplomatic exemptions (Article 15 of VAT Law).

Also, there are some types of exemptions that have no right of refund. While some of them has right of deduction, the others do not have the right of deduction. Some examples of partial exemptions are provided below:

Examples of partial exemptions with right of deduction; exemption for transitions, transferring, transformation, division transactions of enterprises (Article 17/4-c of

[205] Mehmet Maç, (2007), p.1.

VAT Law); exemption for free of charge delivery of computers, hardware and software to the Ministry of Education (Provisional Article 23 of VAT Law); exemption for transactions within the scope of Privatization Law (Provisional Article 12 of VAT Law).

Examples of partial exemptions without right of deduction; importation exemptions (Article 16 of VAT Law); exemptions for cultural and educational purposes (Article 17/1 of VAT Law); exemptions for social purposes (Article 17/2 of VAT Law); exemption for delivery of goods and provision of services to military factories, shipyards, and factory plants (Article 17/3 of VAT Law).

5.2.5. The Right of Deduction

Taxpayers are allowed to deduct paid VAT on supply of goods and services to them and on imported goods and services from calculated VAT of the transactions. Article 29 of VAT Law regulates the issue of right of deduction.

According to this Article 29, in order to deduct charged VAT from calculated VAT the following conditions must be met;

Charged VAT should be;
1) related to purchases and expenses related to business activities,
2) shown also in invoices and similar documents,
3) recorded in legal books;
and
1) related calendar year shall not be exceeded,
2) there shall be no provisions in law preventing deduction[206].

[206] Republic of Turkey Ministry of Finance, (2006), 'Presentations at Screening, Chapter 16: Taxation', 'Agenda Item: VAT', p.58-64.

Article 30 arranges the non-deductible VAT. Transactions that are not subject to VAT, transactions that are exempted from VAT, passenger cars (for those used in commercial activities such as rented are VAT deductible), wasted goods (except the goods wasted as a result of earthquakes, floods and fires in the regions that are declared as force majeure by the Ministry of Finance because of fire), expenses that are not accepted in Personal Income Tax Law and Corporate Tax Law can not be deducted[207].

As far as VAT refund is concerned, the input VAT shown on invoices and similar documents related to the transactions which are exempt from the tax, such as, exportation of goods and services, exemption for petroleum exploration and investments made under an investment incentive certificate, transit transportation, and diplomatic exemption (which are called as full exemptions in Turkey) are deducted from the output VAT, to be calculated on the transactions of the taxpayer which are subject to VAT. If the output VAT is less than the input VAT, then the input VAT which cannot be deducted is refunded to those who perform such transactions, on the basis of principles to be determined by the Ministry of Finance (Article 29/2 of the Turkish VAT Law). On the other hand, taxable persons without registered offices or residence, management board, subsidiary or any another form of business unit, on the territory of Turkey, not involved in the supply of goods and services, are entitled to tax refunds[208]. The right is however limited to foreign national taxable persons participating in trade fairs and transporting activities in Turkey and is exercised only for the supply of prescribed goods and services provided that it is on a reciprocal basis.

For intra acquisition of goods and services in Turkey, VAT refund in the case of input VAT exceeding the collected VAT (output VAT), Article 29/2 provides that;

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[207] Republic of Turkey Ministry of Finance, (2006), ‘Presentations at Screening, Chapter 16: Taxation’, ‘Agenda Item: VAT’, p.58-64.

[208] European Commission, (2007), ‘Screening Report of Turkey, Chapter 16-Taxation’, p.4.

> in case that total amount of Value Added Tax to be deducted in a taxation period is in excess of the total Value Added Tax accrued due to transactions subject to tax, of the taxpayer, difference is carried over to following periods, and is not returned. (Article 29/2 of the Turkish VAT Law)

The general principle is not to give the right of refund to taxpayers. It can be clearly stated that one of the main initiative of not to give the right of refund to taxpayers in Turkey is to prevent the tax fraud or evasion using an auto control mechanism.

5.2.6. Chargeable Event

There are two kinds of chargeable events in Turkish VAT system. One of them is 'domestic chargeable event', and the other one is 'chargeable event in importation'.

Domestic chargeable events are supply of goods and services; issuing invoices and similar documents; supply of each part of goods and services; supply of goods to the buyer in the sales through commission agent or on consignment; commencement of the shipment or delivery of the goods to the transporters or driver; accrual of the value in the distribution or consumption of water, electricity, gas, heating, air conditioning and other types of energy (Article 10 of VAT Law, No.3065).

In the case of importation, chargeable event occurs at the commencement time of the liability to pay customs duty pursuant to Customs Law No:4458 and at the time of registration of customs declaration for the transactions not subject to customs duty (Article 10 of VAT Law, No.3065).

5.2.7. Rates

VAT rate, as specified in Article 28 of the VAT Law, is 10% for each of the transactions that are subject to tax. The Council of Ministers is authorized to increase this rate up to 4 times, reduce it down to 1%, to specify different tax rates for various

goods and services and retail phase for some of the goods. Currently three VAT rates are applied. General rate is 18%. Reduced VAT rates are 1% and 8%.

Goods and services subject to reduced rate are taking place in Lists (I) and (II) annexed to Cabinet Decree No: 2002/4480[209]. The goods and services that are not taking place in these lists are subject to the general rate. 1% rate is applied on the goods and services in the scope of List (I). 8% rate is applied on the goods and services in the scope of List (II). 8% or 18% rate is applied on retail delivery of some goods listed in List (I). Retail delivery means that sale of goods to those excluding VAT taxpayers selling goods as it is or after processing and VAT taxpayers using the goods in their enterprises.

Consequently, as regards to VAT it can be expressed that Turkey uses a general consumption tax covering all goods and services. Turkey's VAT legislation is based on VAT Law, No. 3065 which entered into force on 1 January 1985. It includes the application of a non-cumulative general tax on consumption. It covers all stages of transactions from producer to consumer and calculated on transaction values. Generally, the VAT Law provides for an equal tax treatment of domestic and import transactions.

[209] Katma Değer Vergisi Oranlarına İlişkin 2002/4480 sayılı B.K.K eki Karar Kapsamındaki Oran ve Listeler, (2002), is available at 'http://www.gib.gov.tr/index.php?id=830', (accessed on 03.08.2007).

CHAPTER VI

COMPARISON OF VALUE ADDED TAX SYSTEMS IN THE EUROPEAN UNION AND TURKEY

The comparison of VAT legislation in the EU and Turkey focuses on the areas in which the EU approach has shown a certain impact, such as the subject matter and scope of VAT, taxable person, taxable amount, exemptions, right of deduction, chargeable event and rates.

6.1. The Subject Matter and Scope of Value Added Tax

From the point of view of subject of VAT the main issue is the concept of 'economic activity' in the EU VAT system. While the term 'economic activity' is not specified in the second article concerning the subject matter and scope of VAT, it is used in the Article 9 of the Council Directive 2006/112/EC, while defining the taxable person. The EU VAT system covers all of the economic activities. In order to determine whether a transaction is subject to VAT or not, it should be specified whether the transaction is 'regular' and whether it is 'for consideration' or not. It should be clearly noted that in the EU *acquis*, the term 'economic activity' is very wide.

In Turkish VAT system, the logic is not based on 'economic activity' while determining the subject of VAT. This term is not used in the Turkish VAT Law, No.3065. The system is limited to the concepts of 'commercial, industrial, agricultural, and self-employed activities'. These concepts have taken their roots from the concept of income tax. But the term 'activity', in the first article of the VAT Law, implies the 'regularity' of the transaction[210]. In this sense, casual transactions are not subject to VAT in Turkey.

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[210] Mehmet Maç, (2007), p.2.

This basic difference was also implied at the screening process of Turkey by the EU Commission. The Commission asked Turkey about the transactions in the scope of VAT and mentioned about the existence of concepts of 'in-scope' and 'out-of-scope' in the EU *acquis* different from the Turkish VAT system.

On the other hand in the first article of the Turkish VAT Law, the last subparagraph specifies the deliveries and services arising from other activities. These transactions are subject to VAT even if not in the scope of commercial, industrial, agricultural and professional activities. These activities are mentioned individually. This point is also questioned by the EU Commission at the screening process. The Commission wondered why the Turkish VAT Law considers it necessary to mention these activities individually[211]. This issue is perceived as a disharmony by the EU side. The EU Commission considers that due to the fact that the Turkish VAT Law describes the 'economic activity' very narrowly, the need for additional descriptions has appeared[212].

Moreover, in terms of 'the scope of VAT', it should be stated that there is a disharmony due to the fact that the EU VAT system is arranged to be predicated on 'persons' in principle, while the Turkish VAT legislation has focused on the 'transactions'[213]. This issue is arranged in the second article of the Council Directive 2006/112/EC, by expressing '…by a taxable person'. In Turkish legislation, the main principle is whether the supply of goods or services is within the framework of commercial, industrial, agricultural, and self-employed activities or not. The taxpayer of the VAT is the one who carries out these activities.

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[211] Turkish Revenue Administration, (2006), 'Operational Points at Screening, Chapter 16: Taxation', p.11.

[212] Turkish Revenue Administration, (2006), 'Operational Points at Screening, Chapter 16: Taxation' p.11.

[213] Turkish Revenue Administration, (2006), Note of the meeting between Turkish Revenue Administration and EU Commission on 20 July 2006 in Brussels, p.1.

In this sense, an arrangement would be necessary for the description of the 'economic activity' in Turkish VAT Law at the negotiation process in order to enlarge the scope of VAT in Turkey.

6.2. Taxable Person

In view of taxable person there are no big differences between the two legislations. While EU *acquis* uses the term 'taxable person' or 'person liable for tax', Turkish VAT Law uses 'taxpayer'.

In the EU VAT system, in order to subject a transaction to VAT, that 'economic activity' should be carried out by a taxable person. It means that only supplies made by a taxable person 'acting as such' fall within the scope of the tax under Article 2 of the VAT Directive[214]. In short, the term 'taxable person' intends to cover any person carrying on any independent economic activity.

In Turkish VAT Law, because of the fact that its logic is not based on the taxpayer, in the related article taxpayers are specified individually. There is no reference to 'economic activity' in that article.

In terms of EU context, it is not important whether the person is subject to private law or public law. Therefore, in the new VAT Directive, bodies governed by public law are also subject to VAT, excluding exceptions. However, the Article 13/1 of the Council Directive 2006/112/EC states that public authorities are not to be treated as taxable person in respect of the activities or transactions in which they engage as public authorities, even where they collect dues, fees, contributions or payments in connection with these activities or transactions. If the public authorities engage in other activities such as transport, education, telecommunication, they should be considered as 'taxable person'.

[214] P. Farmer and R. Lyal, (1994), p.111.

From the point of view of 'public administrations' tax liability issue, it can be said that the implementation of Turkey is not different on this heading.

Finally, one point should be emphasized. There is a term, 'fiscal group taxpayer', arranged in Article 10 of the Council Directive 2006/112/EC. This article provides that each member state may treat as a single taxable person established in the territory of the country that, while legally independent, are closely bound to one another by financial, economic and organizational links. The basic effect of this arrangement is to create a single taxable person comprising all the legally distinct members of the group; thus, 'internal' supplies between members of the group are ignored, and the group accounts for VAT only on supplies made to third parties outside the group and deducts input tax only on supplies made to it by third-party suppliers[215]. However, in Turkish legislation there is not a term 'fiscal group taxpayer'.

6.3. Taxable Amount

The expression of the 'taxable base' in Turkish VAT Law corresponds to the 'taxable amount' both in the 6th Directive and the Council Directive 2006/112/EC. The first difference shows itself in the expression of 'for consideration'. This concept is peculiar to EU's VAT legislation. The consideration must be capable of being expressed in money and constitute a 'subjective' value, inasmuch as the taxable amount is the consideration actually received and not a value assessed according to objective criteria[216]. So, it can be clearly said that in the Council Directive

[215] P. Farmer and R. Lyal, (1994), p.118.

[216] European Court of Justice, (1981), Judgment of the Court (Second Chamber) of 5 February 1981, *Staatssecretaris van Financiën v Association coopérative'Coöperatieve Aardappelenbewaarplaats GA'.C*ase 154/80, is available at 'http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEX numdoc&numdoc=61980J0154&lg=en', (accessed on 10.06.2007).

2006/112/EC, the concepts of 'consideration' and 'taxable base/amount' are overlapping[217]. For 'consideration', the principle of subjective value is chosen.

In Turkish legislation the concepts of 'consideration' and 'taxable base/amount' are not exactly overlapping. There is an article in Turkish Law, called as 'fair market value and fee' in Article 27 of VAT Law. This concept includes 'objective elements'. In this context, under the 6th Directive, it can be enounced that the main difference in the view of 'taxable base/amount' is the implementation of 'fair market value and fee', because of the application of the principle of objective value (Article 27 of the VAT Law, No.3065). In this sense, under 6th Directive, while in EU's VAT legislation, supply of services or goods free of charge is not subject to VAT; in Turkish legislation supply of services or goods free of charge is subject to VAT. However, the Council Directive 2006/112/EC lays down a provision related to 'open market value' in Article 72. Within this context the implementation of determining the taxable amount is more similar to that of in Turkish VAT law.

On the other hand, it can be said that the elements included in taxable base/amount and the elements not included in taxable base/amount in EU and Turkish VAT legislation are in harmony. In this sense, it can be said that the rules concerning the taxable amount of VAT are generally parallel with the principles of taxable amount of VAT in the EU[218].

6.4. Exemptions

Generally, with the VAT exemptions, some subjects are out of VAT for economic, social and military purposes. The issue of 'harmonization of VAT exemptions' is so important because of the fact that one of the biggest revenue sources of the EU

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[217] Hülya Bulut, (2005), 'Avrupa Birliği Vergi Uyumlaştırma Sürecinde Katma Değer Vergisi', Marmara Üniversitesi Maliye Anabilim Dalı Doktora Tezi, İstanbul, p.149.
[218] Devlet Planlama Teşkilatı Özel İhtisas Komisyonları, Vergilendirme Alt Komisyonu, (1995), '*Türkiye-AT Mevzuat Uyumu Sürekli Özel İhtisas Komisyonu Raporları*', Vol.2, Ankara, p.26, is available at 'http://ekutup.dpt.gov.tr/ab/uyum/c2b.pdf', (accessed on 28.08.2007).

budget is VAT. While the taxable base is 'shrinking' through the implementation of so many exemptions, the budget revenues are affected by these arrangements. On the other hand, having so many exemptions harms the feature of VAT, called as 'general consumption tax'[219].

The Council Directive 2006/112/EC arranges the exemptions with Articles 131-167. The main difference shows itself in the pre-condition of the general provisions on exemptions. Article 131 provides that;

> without prejudice to other Community provisions, Member States shall exempt the following under conditions which they shall lay down for the purpose of ensuring the correct and straightforward application of such exemptions and of preventing any possible evasion, avoidance or abuse. (Article 131 the Council Directive 2006/112/EC)

In Turkey, no similar pre-condition for exemptions has occurred.

While harmonization with the exemption articles is mandatory; a detailed comparison should be made on this issue.

First, it can be asserted that while the European VAT exemptions intensively focus on social and cultural purposes, the Turkish VAT exemptions focus on economic and military purposes[220]. On the other hand, in Turkish legislation, exemptions are especially provided for public institutions. However, in European context, it can be said that the exemption subject is brought in the foreground, instead of considering the discrimination of public or private institutions[221].

Secondly, some exemptions do not take place in EU VAT legislation, while included in Turkish VAT legislation. Some of them are:

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[219] Nurettin Bilici, (2004), p.167.

[220] Nurettin Bilici, (2004), p.178.

[221] Nurettin Bilici, (2004), p.178.

1) For the taxpayers who are renting railway vehicles or operating them in different ways, delivery and importation of these railway vehicles to taxpayers, modification, repair and maintenance services related to these vehicles to taxpayers, deliveries and services related with the manufacturing of these vehicles to taxpayers are exempted from VAT. (Article 13/a of VAT Law, No.3065),
2) Exemption for Petroleum Exploration (Article 13/c of VAT Law, No.3065),
3) Exemptions for military purposes (Article 17/3 of VAT Law, No.3065).

Finally, some exemptions do not take place in Turkish VAT legislation, while included in EU VAT legislation. Some of them are:
1) The supply by the public postal services of services other than passenger transport and telecommunications services, (Article 132/1-a of the Council Directive 2006/112/EC),
2) Hospital and medical care and closely related activities undertaken by bodies governed by public law or, under social conditions comparable with those applicable to bodies governed by public law, by hospitals, centres for medical treatment or diagnosis and other duly recognized establishments of a similar nature (Article 132/1-b of the Council Directive 2006/112/EC),
3) The provision of medical care in the exercise of the medical and paramedical professions as defined by the member state concerned (Article 132/1-c of the Council Directive 2006/112/EC),
4) Supplies of human organs, blood and milk (Article 132/1-d of the Council Directive 2006/112/EC),
5) Services supplied by dental technicians in their professional capacity and dental prostheses supplied by dentists and dental technicians (Article 132/1-e of the Council Directive 2006/112/EC).

6.5. The Right of Deduction

From the point of view of the right of deduction, both in EU and in Turkey, a taxable person has the right to deduct the input VAT incurred on the goods and services used for making the supplies from the output VAT payable on his/her supplies. If the collected VAT exceeds the VAT amount paid for the inputs, difference between these two amounts is paid to the tax administration.

However, in the case of the VAT amount paid for the inputs exceeding the collected VAT, the implementation of these two VAT legislations acquires a different character. According to the EU's VAT legislation, the excess between these two amounts is refunded to the taxpayer instantly or is carried forward to the following period depending on demand of the taxpayers. In Turkey, there is not an option right for taxpayers. When the VAT amount paid for the inputs exceeds the collected VAT, Article 29/2 provides that;

> in case that total amount of Value Added Tax to be deducted in a taxation period is in excess of the total Value Added Tax accrued due to transactions subject to tax, of the taxpayer, difference is carried over to following periods, and is not returned. (Article 29/2 of Turkish VAT Law, No.3065)

The general principle is not to give the right of refund to taxpayers. Only full exemptions give the right of refund. Article 32 arranges the details of this implementation. In this sense, it can be asserted that the main disharmony in this field is the option right of the taxpayer for demanding instantly refund of the excess amount of the VAT when the VAT amount paid for the inputs exceeds the collected VAT. But Article 183 of the VAT Directive provides that where for a given tax period the amount of authorized deductions exceeds the amount of tax due, the member states may either make a refund or carry the excess forward to the following period according to conditions which they will determine. Also the same article gives to member states option for refusing to refund or carrying forward if the amount of the excess is insignificant (Article 183 of the Council Directive 2006/112/EC).

Finally, while the EU legislation considers the 'invoice' sufficient to give the right of deduction, in Turkish legislation, in order to deduct charged VAT from calculated VAT, charged VAT, should be related to purchases and expenses in business activities; must be shown also in invoices and also be similar documents; and recorded in legal books. These three conditions must be provided together in Turkish system.

6.6. Chargeable Event

From the point of view of chargeable event in the case of supply of goods and services, the expression 'the chargeable event shall occur and the tax shall become chargeable when the goods or services are supplied' in the new VAT Directive and the expression 'the chargeable event occurs in the case of delivery of good or performance of service, when the goods delivered or the services are performed' in Turkish VAT Law are parallel to each other.

In terms of importation, Turkish Law has much larger arrangements. In VAT Directive, Article 70 provides that 'the chargeable event shall occur and the tax shall become chargeable when the goods are imported'. However, in Turkish legislation chargeable event depends on the commencement time of the liability to pay customs duty or the time of registration of customs declaration for the transactions not subject to customs duty.

Consequently, it can be expressed that there is harmonization on the issue of 'chargeable event' in VAT. Also, in the screening process there were not any statements made about the disharmony on the chargeable event.

6.7. Rates

As far as VAT rates are concerned, the main problem can be seen in implementation of the 1% rate. In the EU, member states may apply one or two reduced rates of not

less than 5%. So, it can be stated that a need for possible upward adjustment at the 1% rate might emerge in the near future.

On the other hand, different rates are applied to some transactions at the different phases in the supply chain. The legal base of this implementation is the Article 28 of the VAT Law, No.3065. This article provides that ‘The rate of Value Added Tax shall be 10% for every taxable transaction. The Council of Ministers is authorized to increase this rate fourfold, to reduce it to 1%, and within these limits, to set different rates for different goods and services and for the retail phase of particular goods’. For example, while the rate applied to linden tree for the phases from the beginning to the retail stage is 1%, the rate applied at the retail stage is 18%. It can be expressed that implementation of different rates at the different stages of supply chain does not comply with the EU *acquis*, especially in terms of the principle of tax neutrality.

CHAPTER VII

CONCLUSION

The main aim of this thesis was to analyze the harmonization position of Turkey on the issue of value added tax after the screening process with the European Union has been completed. In relation to that, the possible impact of the integration process with the European Union on Turkey's VAT system was one of this thesis's concerns.

As it is known, on October 3, 2005, European Union accession negotiations with Turkey were opened with the adoption of the Negotiation Framework by the Council of the European Union. After then the screening process, an analytical examination of the *acquis*, was started on October 20, 2005 and carried on until October 13, 2006 with Turkey. In this respect, explanatory screening - the first phase of screening - of Turkey for the taxation chapter was held on June 6-7, 2006 in Brussels and the second phase - bilateral meetings - was held on July 11-12, 2006. The Ministry of Finance and Turkish Revenue Administration are the responsible institutions of taxation chapter at the screening meetings. Therefore, the screening process and the meetings held in Brussels on taxation have constituted one of the main sources for the comparison of VAT legislations. In this sense, the thesis included the recent developments and improvements on the issue of VAT.

In this context, first EU tax policy was examined as a separate issue and the legal basis of tax harmonization in the EU context was studied in order to supply background information. The thesis mainly focused on studying the differences between the EU and Turkish VAT legislation taking into account the fact that harmonization of the Turkish tax legislation with that of the EU is amongst the priorities for Turkey during the accession negotiations. The thesis primarily argued that there would be no binding benchmarks on VAT at this stage, especially since the Council Directive 2006/112/EC has been adopted. This Directive codifies the provisions implementing the common system of VAT and is regarded as 'VAT

Directive'. This VAT Directive is a recasting of the Sixth Directive 77/388/EEC on the common system of value added tax and the uniform basis for assessment which has been amended more than thirty times since it was adopted. It codifies the provisions of Directive 77/388/EEC from 1 January 2007 without changing the essence of the legislation in force. Therefore, the main focus has been given to Council Directive 2006/112/EC in this thesis, while examining the EU's VAT legislation.

In terms of explaining the general scope of the taxation policy in the EU, the thesis first of all summarized the literature on tax harmonization in the EU. In addition to that initiatives for developing the European taxation policy were analyzed. Due to the fact that logical side of the harmonization process has a considerable impact on understanding why Turkey needs a harmonization with the EU acquis, the thesis gave importance to explain the basic principles of EU tax policy- subsidiarity, neutrality and unanimity.

After then, the EU tax harmonization has been explained in terms of its legal basis. The legal framework has been examined under three parts. The first part was devoted to primary sources, by examining all of the related articles of the EC Treaty in detail. Secondly, the basic features of the types of secondary sources- regulation, directive, decision, recommendation, opinion, resolution- were studied on the basis of their binding forces. As an alternative categorization of secondary EU tax law, the analysis continued with the survey of Borgsmit in terms of conflict rules, limitation on national legislative power by clauses and optional rights of member states.

The main aim of the thesis has started to illustrate itself in Chapter 4. This chapter especially focused on the VAT legislation of the EU. The Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, was examined topic by topic. These topics were chosen depending on the screening process, highlighting the areas which need for further analysis. These topics were determined as the subject of VAT, taxable person, taxable amount, exemptions, and

the right of deduction, chargeable event and rates. The same topics were scrutinized in the Fifth Chapter, in terms of Turkish VAT legislation. While the Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax was taken as the base for the EU side, the Turkish VAT Law, No.3065 was chosen as the primary source for illustrating the legal aspects of the VAT in Turkey.

The comparison of VAT legislation in the EU and Turkey was made in Chapter 6. This comparison focused on the areas in which the EU approach has shown a certain impact.

As far as the subject matter and scope of VAT is concerned, it can be clearly asserted that an arrangement would be necessary for the description of 'economic activity' in Turkish VAT Law at the negotiation process in order to enlarge the scope of VAT in Turkey.

In view of taxable person, there would be a need to be included the concept of 'fiscal group taxpayer' into Turkish VAT Law. In terms of taxable amount, the expression of 'for consideration' is peculiar to EU's VAT legislation. While in Turkish VAT Law, the principle of objective value is adopted for determining the taxable amount by implementation of 'fair market value and fee', in EU VAT legislation, the principle of subjective value is chosen by implementation of the expression of 'for consideration'.

On the issue of exemptions, it can be asserted that while the European VAT exemptions intensively focus on social and cultural purposes, the Turkish VAT exemptions focus on economic and military purposes. On the other hand, in Turkish legislation, exemptions are especially provided for public institutions.

From the point of view of the right of deduction, in the case of the VAT amount paid for the inputs exceeding the collected VAT, the implementation of EU and Turkish VAT legislations acquires a different character. According to the EU's VAT

legislation, the excess between these two amounts is refunded to the taxpayer instantly or is carried forward to the following period depending on demand of the taxpayers. In Turkey, there is not an option right for taxpayers and the general principle is not to give the right of refund to taxpayers. Only full exemptions give the right of refund. In this sense, it can be asserted that the main disharmony in this field is the option right of the taxpayer for demanding instantly refund of the excess amount of the VAT when the VAT amount paid for the inputs exceeds the collected VAT.

For the concept of chargeable event, it can be expressed that there is harmonization on this topic.

Lastly, the main problem can be seen on the issue of rates, especially on the implementation of the reduced rate of 1%. It can be stated that a need for possible upward adjustment at the 1% rate might emerge in the near future. On the other hand, it can be expressed that implementation of different rates at the different stages of supply chain does not comply with the EU *acquis*, especially in terms of the principle of tax neutrality.

In this respect the European Commission recommendations on the issue of VAT through the Screening Report should be stated. As it is known, 'Screening Report of Turkey, Chapter16- Taxation', was approved at the Council of the European Union, and was published on 24 January 2007. Its main focus is on the fact that 'Turkey has partially aligned its legislation in the field of value added tax and VAT system of Turkey follows the main structure of the legislation of the EU'. However, this report also added that especially in the fields of deductions, exemptions, tax refunds and the application of reduced rates, there are many differences. The main point that is emphasized as having a disharmony is Turkey's application of two reduced rates (8% and 1%). The use of a reduced rate of 1% is not seen as in line with the *acquis*, nor is the scope to which the reduced rates are applied. This includes the reduced rate of 8% introduced by Turkey for textile products, which is not allowed under the *acquis*.

Another important issue is the fact that application of a separate rate for supplies prior to the retail stage is not permitted under the *acquis*. Additionally, in this report it is stated that the definitions of 'tax payer', 'taxable person', or 'person liable' for payment of VAT need streamlining in order to be in line with the *acquis*. It is especially asserted that the same necessity goes for Turkey's definition of what is considered as an economic activity for the purposes of VAT.

Moreover, according to the European Commission, the *acquis* uses the concept of 'place of supply' of goods or services, which is different from the concept of 'place of delivery'. Furthermore, Turkey's legislation is unclear in terms of the distinction made between 'tax-base' and 'taxable amount'. Turkey should also bring its legislation relating to partial exemptions for small enterprises in line with the *acquis*[222].

Finally, recommendations in the field of VAT harmonization with the EU *acquis* can be determined under titles, taking into account the taxation screening report of Turkey. First, arrangements concerning the terms economic activity, place of supply of goods and services, taxable amount, arrangements about taxing the travel agencies, second-hand goods, works of art and collectors should be assessed in the framework of full membership perspective[223]. An adjustment, for abolition of fiscal frontiers through giving up taxation of importation and for harmonization with the EU *acquis* for small enterprises, should also be emerged at the stage of full membership.

Consequently, it can be concluded that due to the fact that the logical base, on which Turkish VAT legislation is depending, is nearly identical with that of the EU, there is no need to make major harmonization laws in VAT field. As it is stated in the

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[222] European Commission, (2007), 'Screening Report of Turkey, Chapter 16-Taxation', p.11.

[223] Devlet Planlama Teşkilatı, (2007), 'AB Müktesebatına Uyum Programı, Vergilendirme', is available at 'http://ekutup.dpt.gov.tr/ab/ABMuktesebati/ABMuktesebati.asp', (accessed on 25.07.2007), p.235.

'Taxation Screening Report of Turkey', VAT system of Turkey follows the main structure of the legislation of the EU. But of course, Turkey needs some arrangements on some descriptions, such as economic activity, taxable amount and taxable person, which are seen as differences, by European Union, constituting a large number of disharmony areas.

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APPENDICES

APPENDIX A:

VALUE ADDED TAX REVENUES SHARE IN TOTAL BUDGET TAX REVENUES

TABLE 1

VALUE ADDED TAX REVENUES SHARE IN TOTAL BUDGET TAX REVENUES

(1985 - 2006)

(THOUSAND NTL.)

YEARS	TAX REVENUES	DOMESTIC VAT REVENUES	SHARE IN TAX REVENUES	VAT ON IMPORTATION REVENUES	SHARE IN TAX REVENUES	TOTAL VAT REVENUES	SHARE IN TAX REVENUES
1985	3.829	567	14,8	384	10,0	951	24,8
1986	5.972	1.040	17,4	528	8,8	1.568	26,3
1987	9.051	1.563	17,3	1.004	11,1	2.567	28,4
1988	14.232	2.660	18,7	1.517	10,7	4.177	29,3
1989	25.550	4.176	16,3	2.285	8,9	6.461	25,3
1990	45.399	7.650	16,9	4.721	10,4	12.371	27,2
1991	78.643	14.541	18,5	8.291	10,5	22.832	29,0
1992	141.602	27.053	19,1	15.035	10,6	42.088	29,7
1993	264.273	50.892	19,3	30.985	11,7	81.877	31,0
1994	534.888	110.918	20,7	65.824	12,3	176.742	33,0
1995	1.084.350	212.119	19,6	142.861	13,2	354.980	32,7
1996	2.244.094	419.167	18,7	323.859	14,4	743.026	33,1
1997	4.745.484	861.262	18,1	700.300	14,8	1.561.562	32,9
1998	9.228.596	1.589.060	17,2	1.136.023	12,3	2.725.083	29,5
1999	14.802.280	2.433.262	16,4	1.731.072	11,7	4.164.334	28,1
2000	26.503.698	4.487.808	16,9	3.891.746	14,7	8.379.554	31,6
2001	39.735.928	7.289.543	18,3	5.149.317	13,0	12.438.860	31,3
2002	59.631.868	11.542.749	19,4	8.857.452	14,9	20.400.201	34,2
2003	84.316.169	15.389.547	18,3	11.641.552	13,8	27.031.099	32,1
2004*	101.038.904	18.666.461	18,5	15.658.747	15,5	34.325.208	34,0
2005*	119.250.807	20.401.096	17,1	17.879.333	15,0	38.280.429	32,1
2005**	131.948.778	22.038.878	16,7	20.224.772	15,3	42.263.650	32,0
2006**	151.265.721	25.291.010	16,7	25.432.537	16,8	50.723.547	33,5

(*) DISCLAIMERS AND REBATES ARE INCLUDED TO FIGURES TO PROVIDE THE SAME BASE OF PREVIOUS YEARS

(**) LOCAL ADMINISTRATION, FUNDS, DISCLAIMERS AND REBATES ARE INCLUDED TO FIGURES TO PROVIDE THE SAME BASE OF PREVIOUS YEARS