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Vogtländische Straßen-, Tief- und Rohrleitungsbau GmbH Rodewisch (VSTR) v. Finanzamt Plauen – VAT Triangulation v. Drop Shipments

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It is not every day that an American firm with no physical presence in the EU finds itself in the middle of an EU VAT controversy that significantly develops the law. However, the September 27, 2012 decision of the European Court of Justice (ECJ) does just that. The case is *Vogtländische Straßen-, Tief- und Rohrleitungsbau GmbH Rodewisch (VSTR) v. Finanzamt Plauen*.  

How did this happen? Although nothing in the case expressly states this to be the case, it appears that Atlantic International Trading Company (as a middleman in an otherwise all-European transaction) treated its part in the transaction like an American drop shipment, instead of like an EU triangulation. Differences in the tax treatment of what is essentially the same commercial transaction under the retail sales tax (RST) and the EU VAT are significant, and this difference is worthy of notice.

**VSTR - Facts of the case**

In November 1998 Atlantic International Trading Company (AIT), an American company established in New York, NY, purchased two stone-crushers from VSTR, a firm established in Germany. AIT quickly re-sold the stone-crushers to an end user established in Finland. The VSTR/AIT contract was “ex works,” that is AIT was responsible for transporting the goods from Germany, and AIT did this by hiring a heavy equipment transport company to move the goods by road and sea directly to Finland (not first to the USA, and then to Finland).

In the EU VAT this type of transaction is known as an ABC, or triangular transaction. It is composed of two back-to-back sales, A/B followed by B/C, with a single delivery from A directly to C. AIT is the middleman at point B of the triangle. In the US this same transaction is called a drop shipment.

This article compares the tax treatment of drop shipments under the RST with triangulation transactions under the EU VAT. Under both systems when a single integrated transaction involves third-party middlemen compliance can be difficult. Importantly, the difficulties are not the same difficulties. The treatment is very different.

**Drop Shipments**

Drop shipment transactions involve three parties and two sales. The first sale occurs between A the supplier (drop-shopper) and B the retailer (middleman). The second sale occurs between B and his customer, C. Delivery is direct. A ships directly to the retailer’s customer C. B never touches the goods. These are the precise fact of the VSTR transaction.

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1 Case C-587/10 (September 27, 2012).
In large measure the RST relies on sellers to collect sales tax on taxable sales from their buyers, then report the sale and remit the tax due. Under *Quill v. North Dakota*, 504 U.S. 298 (1992) these obligations cannot be imposed on a seller that does not have nexus in the taxing jurisdiction. Thus, in a multi-jurisdictional drop shipment, B can easily sell to C without incurring collection responsibilities if B does not have physical presence in C’s jurisdiction, and if he has A ship the goods directly to C. Is this what AIT saw in its stone-crusher re-sale? Did it see a VAT-taxable transaction to a jurisdiction where it had no physical presence, and did it assume that it therefore had no collection or reporting requirements under German or Finnish VAT?

Some RST jurisdictions respond to the avoidance pattern that *Quill* permits by requiring A to collect the tax from C. In the *VSTR* fact pattern this would mean that the German firm (VSTR) would need to collect the tax due and the report the transaction. The problem with this solution is that the American RST is based on the sales price to C, and A has no idea what C paid B for the goods. Firm A knows what B paid to A, but it has no idea what C has paid B. In addition, if B is a good middleman he will not be anxious to let A know what C is willing to pay for the goods for fear of being cut out of the next sale.

What most states have done in this situation is to expand the definition of “retail sale” to include the drop-shipping third-party supplier. Particularly in instances where the third-party supplier drop ships to in-state customers from in-state inventory, drop shipments are deemed to be retail sales. Even though this is not the fact pattern in the *VSTR* case, it is clear where the American bias is in drop shipment transactions – it is to transfer the middleman’s tax collection responsibilities to the drop shipper, not the pursue the middleman. Exceptions are available under the American RST. The most common exception is for the drop-shipper who can “prove” that they are in fact making sales for resale. This “proof,” however, is not always a simple matter.

Many states limit acceptable “proof” narrowly, allowing sale-for-resale status only to third-party suppliers who receive valid in-state certificates of resale from their out-of-state retailers. This certificate, in turn, is only issued to out-of-state retailers that promise, in spite of *Quill*, to collect the state’s sales tax on sales to in-state consumers. If rules like this operated in the EU, then it would be VSTR’s (the German company’s) responsibility to secure the “proof,” and AIT knew it had not made any promises to collect any VAT in the EU. It was not registered in any of the EU member states, and never filed VAT returns. AIT may have though, “if there is VAT due, it certainly is none of my responsibility to collect it, report it or remit it.

Additional complexities arise under the American RST when the drop shipper supplies from inventory located outside the state. Delivery terms are a factor that alters the drop shipper’s obligations in some states. This again would be something that the German firm, VSTR, would need to be concerned with, not AIT.

This is not the end of the complexity for the American RST. Divergent rules for drop shipments are drafted under an entirely different reading of the drop shipment fact.
pattern in some states. These rules are found in California, Connecticut, Rhode Island, Massachusetts, Kansas, Nevada and Wisconsin. Their legal underpinnings differ from the norm. Instead of focusing on the in-state delivery element, these rules focus on the third-party supplier’s status as a "former owner" of the property. Delivery by a “former owner” is deemed to be a retail sale by the drop shipper to the end consumer. But this again absolves a middleman without physical presence in the buyer’s jurisdiction from collection responsibilities.

The authority of Quill is so strong in the American practice that it is easy to how middlemen (like AIT) can be looking inward (instead of reading the law). They can very easily be thinking: “If I can be sure I have no physical presence in the final buyer’s or the seller’s jurisdiction, I can be reasonably sure that whatever the tax rules are where A and C are located, these are rules that will not apply to me.” An additional benefit that would not go unnoticed is that by not being involved in VAT collection and reporting responsibilities, a permanent establishment for income tax purposes is similarly not created.

Is this what AIT thought? There is nothing in the trial record to indicate this one way or the other, but the pattern of AIT’s action in this case is distinctly American. The problem is, the transactions are European, not American, and different rules apply in the VAT.

**Triangulation**

There is nothing comparable to Quill in the EU VAT. In the EU no tax determinations turn on whether or not a business does or does not have nexus with a taxing jurisdiction. Article 9(1) of the VAT Directive defines a taxable person globally. A taxable person is any person who independently carries out in any place any economic activity whatever the purpose or result of that activity.

But, Article 9(1) does not mean that every American business is within the scope of the German or Finnish VAT, for example. To be within the scope of the German or Finnish VAT an American business would need to make a taxable supply within the German or Finnish territory.2

The question that AIT needed to ask in 1998 was not whether or not it had nexus with Germany or Finland, but whether or not it made a supply of goods in either Germany or Finland. This answer is simple. Yes, AIT did make a supply of goods in either Germany or Finland. The problem is, it was not clear at the time of the AIT purchase and re-sale contracts in which country (Germany or Finland) that AIT had made a supply of goods.

The confusion in this case comes from the fact that the supply is wrapped in a triangulation. We know now that, depending on the facts of the case the supply that AIT

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2 Articles 14 through 19 indicate the supplies of goods that are subject to VAT, Articles 20 through 23 indicate the intra-community acquisitions, Articles 24 through 29 indicate the services that are subject to VAT, and Article 30 specifies the importation rules.
made could be either in Germany or in Finland. How this problem is resolved is the heart of the VSTR decision as well as two cases decided earlier, one in 2010 (Euro Tyre Holding v. Staatssecretaris van Financiën3) and the other in 2006 (EMAG Handel Eder OHG v. Finanzlandesdirektion für Kärnten (Berufungssenat II)4). Importantly, at the time AIT entered into its contracts for the purchase and re-sale of the stone-crushing machines none of the law in this area was very unclear.

AIT might not be blamed in this circumstance for thinking like an American, and assume that something like Quill might apply in this situation, and that it would be found to have no tax obligations in the EU because it had no physical presence in the EU.

From a commercial perspective, a triangular transaction under the EU VAT is no different than a drop shipment transaction under the American RST. A sells to B, and then B re-sells to C. Two contracts (invoices and payments) are involved, and the goods are delivered from A to C. Additional intermediate parties are possible, but the critical elements remain the same – the contracts follow the buy/sell chain, but the goods go directly from the first party A to the last party C.

Triangulations (like RST drop shipments) are complicated when a supplier’s customer resides in another Member State. Article 138 of the VAT Directive requires suppliers to zero-rate their supplies of goods (dispatched or transported) to a taxable person in another Member State. The destination must be outside the supplier’s territory (but within the EU) and the transport must be to a Member State other than the State where the transport begins. If goods are not (dispatched or transported) to a taxable person in another Member State, then the transaction is not zero-rated. VAT is due in that jurisdiction. VAT must be collected, and remitted. Returns must be filed. On the return, a VAT ID (which is awarded to the taxpayer upon registration) is needed.

A classic cross-border triangulation would, for example, involve A in Italy selling goods to B in the Czech Republic. B would resell to another enterprise in Austria, C. If the delivery is from Italy to Austria, then it is clear that a zero-rate applies (Article 138), but it is not so clear whether it is the A/B transaction that is zero-rated, or the B/C transaction. The ECJ determined in the EMAG decision that when this occurs there is only one zero-rated sale. Both the A/B and the B/C transactions cannot be zero-rated if there is only one dispatch or transport. The difficult question is which transaction is zero-rated, A/B or B/C? This question was addressed in Euro Tyre.

This ABC hypothetical is basically the VSTR fact pattern with one important difference – the middleman (AIT) is located in the US, not the EU.

It is clear now that the dispatch or transport in a triangular transaction will be associated only with one of the two supplies, A/B or B/C, and the other supply occurs either in the Member State of departure or the Member State of arrival (depending on the facts of the case). If A performs the transport it is the A/B transaction that is zero-rated.

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3 Case C-430/09 (December 16, 2010).
4 Case C-245/04 (April 6, 2006).
If C performs the transport it is the B/C transaction that is zero-rated. The most difficult cases involve transport by B, which is of course the situation in VSTR.

Thus, it is clear EU law that because AIT purchases the stone-crushing machines in the EU and sells them on to an EU customer that it is subject to VAT. However, because AIT (as a middleman) transports the stone-crushers to Finland it is not clear whether it is the VSTR/AIT transaction, or the AIT/Finnish transaction that is zero-rated. Or in other words whether a German return is due with German VAT (AIT would pay German VAT to VSTR, and file a return to get the VAT back when it made the sale to Finland), or a Finnish return is due with Finnish VAT (AIT would collect Finnish VAT from the Finish buyer, file a Finnish return, and remit the funds).

The most curious event in the VSTR case occurs when VSTR sells the stone-crushing machinery to AIT. This event is what makes the case. VSTR asks for AIT’s VAT ID. Of course, AIT does not have one. AIT is registered nowhere. The decision indicated that instead of providing its VAT ID or indicating that it was (or was not) registered, “… [AIT] replied that it had sold the [stone-crushing] machines on to a company established in Finland and gave the seller the VAT identification number of the Finnish company. The branch [the German seller] verified this information.”

Using the Finnish VAT ID, VSTR issued an invoice to AIT without VAT, under the belief that the VSTR/AIT transaction was a zero-rated intra-community supply. The German national tax authority (NTA) audited and found that the supply could not be VAT-exempt. VSTR appealed the lower court’s decision to the Bundesfinanzhof (Federal Finance Court). The Bundesfinanzhof made a number of findings. Two of them are critical. First, it found that the transaction in question was triangular (two successive supplies are followed by a single movement of goods). Secondly, it attributed the transport to first transaction VSTR/AIT. The ECJ agreed with this result.

Under the narrow holding of the case the German NTA’s audit is overturned. German VAT was not due on the first leg of the transaction, and although not directly part of the holding it is clear that AIT had been obligated to collect VAT on the AIT/Finnish company transaction. AIT was a taxpayer that made a Finnish supply.

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5 VSTR at ¶15 & Opinion of Advocate General Cruz Villalón, Vogtländische Straßen-, Tief- und Rohrleitungsbau GmbH Rodewisch (VSTR) v. Finanzamt Plauen, Case C-587/10 at ¶18. Note: there is apparently some difficulty in the German system when trying to confirm that a particular VAT ID is associated with a specific named party. Secrecy concerns limit access, so that the only thing that can be confirmed is the validity of a VAT ID, but not party’s name associated with the number.

6 The German court of first-instance, the Sächsisches Finanzgericht (Finance Court, Saxony), upheld the NTA. The specific reason for the NTA’s denial was that German law required an enterprise making an intra-Community supply to secure his customer’s VAT ID and place that number on the invoice. Paragraph 17c(1) of the Umsatzsteuer-Durchführungsverordnung (Regulation implementing the UStG) indicates:

In the case of intra-Community supplies (Paragraph 6a(1) and (2) of the UStG), the trader to whom this provision applies must provide evidence in the accounts that the requirements for exemption from tax have been complied with, including the VAT identification number of the person acquiring the goods. The accounts must show clearly and in an easily verifiable manner that the requirements have been met.

VSTR, at ¶13 (emphasis added).
Thus, unlike in the US where Quill holds that only businesses that have physical presence in a jurisdiction can be obligated to collect the RST, the EU VAT has no such rule, and even a remote middleman like AIT who makes supplies in the EU is obligated to charge VAT.

The single market makes the VAT treatment of cross-border triangulations complex. Recognizing this, a simplification was designed to deal with the most common triangulation patterns. Simplification was considered necessary because of the volume of commercial activity involving middlemen. The critical provisions are found at Articles 41, 42, and 141 of the VAT Directive.

The focus of these provisions is to mitigate costly registration requirements that fall on the middleman’s shoulders. If we use the prior example, this would mean that – under simplified rules B, established in the Czech Republic, would not need to register in Italy, nor would B need to account for acquisition VAT there. In addition, simplification will relieve B from accounting for acquisition VAT in Austria.

The simplification framework accomplishes its work by deeming B’s acquisition of goods (dispatched by A from Italy) to have already been subject to VAT in Austria. But this is not all. Because B would still need to register for VAT in Austria to report the onward sale to C, this requirement is also removed. Under simplification all B needs to do is to “designate” C as the party to report VAT under the reverse charge mechanism.

But, what if B does not register and account for VAT in the Czech Republic? Article 41 is designed to provide assurance that B will do so. Article 41 states that acquisition VAT is also due on the same transaction in the Member State that issued B’s VAT ID (the number under which B’s intra-community acquisition was made). This “safety net” provision essentially results in double taxation. However, it does not apply if B has already accounted for VAT in Austria.

If the safety net applies, then B must account for VAT in the Czech Republic. It may not deduct this amount even if B eventually registers and accounts for VAT in Austria. The rules indicate that instead of being permitted to take an immediate deduction for VAT paid on the same return on which the acquisition is reported, “B” is required to apply for a refund in the Czech Republic. At this time B will need to supply proof that it has accounted for VAT in Austria. Absent this proof, the transaction will be double taxed.

The intention is to make triangular transactions secure by relying on taxpayer self-interest. Taxpayers should want to avoid the safety net by accounting for VAT in Austria in advance of the filing requirements in the Czech Republic.

There is one caveat. Simplification does not extinguish B’s acquisition of the goods; simplification simply deems B’s acquisition to have already been subject to VAT. The distinction is important. The deeming structure leaves open B’s obligation to file a
recapitulative statement. In fact, Article 42(b) expressly conditions simplification on fulfillment of this requirement.

Conclusion

Drop shipments, triangulations or ABC transactions are a common part of global commercial practice. Whether in the US under the RST or overseas under a VAT there are double taxation traps for the unwary, and substantial penalties for non-compliance.

It is important to read the local law in this area and not assume that what applies in the American RST, for example, equally applies in the EU VAT. Even though the RST and the VAT are both destination-based transaction taxes there are important differences in application.

AIT could have accomplished all that it wanted to if it simply registered for VAT in another EU jurisdiction (not Germany or Finland), say for example in the UK. If it then applied triangulation simplification no VAT would be due. The only concern would be to avoid the safety net provision in Article 41 (which would require VAT due in the UK) by simply accounting for VAT in Finland.