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## ***VAT & the cloud—understanding your VAT obligation***

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### ***In brief***

Value Added Tax (VAT), including Goods and Services Tax (GST), and similar consumption tax systems have been implemented in more than 150 countries around the world, with seven more countries considering implementation by 2013. VAT is a transaction based tax which applies to nearly all transactions where either the purchaser or the seller is located in a VAT jurisdiction. Whether the seller has any physical presence in a country is often not determinative of whether it has any VAT obligations in the country.

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### ***In detail***

#### ***How does VAT work?***

VAT registered businesses charge output tax at the applicable rate on all taxable supplies (sales) and recover input tax incurred at the applicable rate on purchases. Where the output tax exceeds the input tax, the business has to make a payment to the revenue authorities for the balance. Where the input tax exceeds the output tax, the business is generally entitled to a refund.<sup>1</sup> VAT should therefore, if managed properly, not represent a cost to most businesses.

Even though VAT should not be a cost, the tax could have a real impact on profit margins where the tax has not been considered as part of the pricing decision, for example because the business was not

aware that a particular transaction was subject to VAT. The revenue impact could be up to 20% in jurisdictions such as Sweden or Norway where the standard VAT rates are 25%.<sup>2</sup>

#### ***How does VAT apply to cloud computing?***

VAT generally applies to any supplies of goods and services made by a business located in a VAT jurisdiction. Most VAT jurisdictions make a clear distinction between supplies defined as goods and supplies defined as services. This distinction is relevant to determine whether a particular transaction is subject to VAT and where.

Simply speaking, a supply of goods is generally subject to VAT if the goods are located

in a VAT jurisdiction at the time of sale. A supply of services, on the other hand, can be subject to VAT where the supplier is located, where the recipient is located, and/or where the services are performed, depending on the jurisdiction and the type of service provided.

In the EU, 'a supply of goods' is defined as "the transfer of the right to dispose of tangible property as owner."<sup>3</sup> A supply of services means "any transaction which does not constitute a supply of goods."<sup>4</sup> By deduction, any transactions involving the Cloud, such as electronic storage and webhosting, are considered services for EU VAT purposes.

Other VAT jurisdictions have similar definitions of goods and services. As such, services delivered via the Cloud would therefore generally be regarded as a supply of services for VAT purposes.

Where services are delivered through the Cloud and supplied by a seller located in the same country as the customer, the VAT treatment is usually straightforward. Provided the seller is established and VAT registered in the VAT jurisdiction, VAT is simply added to the price of the service. If a sale is made to a business customer, VAT should be itemized separately for recovery purposes. If invoiced to a private individual and a single price is shown with no mention of VAT, VAT is generally considered as being included within the stated price.

Where the seller and the customer are located in different territories, the VAT treatment becomes more complex. This is highlighted in the next section by the number of different approaches taken by governments around the world to deal with this scenario.

***Global trends in the VAT treatment of cross-border services delivered via the cloud***

Governments around the world are looking for ways to collect indirect taxes on services delivered electronically by non-resident providers, including providers of services delivered from the Cloud to private individuals or non-VAT registered businesses, in their country. Some countries impose an obligation on the customers to self-account for the VAT or withhold it. Others require the non-resident to register and account for VAT whilst others do not (yet) seek to tax these transactions.

***European Union***

***B2B services***

The general rule in the European Union (EU) is that services supplied to taxable businesses are subject to VAT in the country where the buyer is established. This rule also applies to services provided via the Cloud. Any services provided via the Cloud by a US company without any presence in the EU would therefore be subject to VAT at the rate applicable in the country where its business customers are located.

Rather than require the US company to register and account for VAT, the rules provide that the EU business buyer should self-account for the VAT due via the reverse charge mechanism (similar to a US use tax). The buyer will also generally be entitled to an input tax credit for the same amount as the output tax accounted for, thus eliminating any cash-flow costs for the buyer.

In summary, if only services delivered from the Cloud are provided by a non-EU seller, with no presence in the EU, to EU taxable businesses, no EU VAT obligations should arise for the seller. While there is no specific EU-wide rule for verifying that a customer qualifies as an EU taxable business, at a minimum, it is recommended that the non-EU seller obtain and verify the business customer's VAT registration number on sales exceeding € 500 in any quarter.

***B2C services***

Generally speaking, supplies of services to private, non-VAT registered individuals (as well as non-VAT registered businesses) residing in the EU are subject to VAT in the country where the supplier is located, unless the supply is made through a fixed establishment (akin to, but not

the same as, a branch for income tax purposes) in the EU. However, special rules apply where a non-EU business, without any presence in the EU, supplies 'electronically supplied services' (ESS) to private individuals residing in the EU.

ESS is defined to include "services which are delivered over the Internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, and impossible to ensure in the absence of information technology".<sup>5</sup>

While it is critical that the appropriate care be taken when determining the proper VAT treatment of any particular service, referring to this definition, services delivered from the Cloud often fall under the broad EU definition of ESS.

Supplies of ESS by a non-EU business, without any presence in the EU, are subject to VAT at the rate applicable in the country where its customers reside, and the non-EU supplier is required to either:

Register and account for VAT in each country where its customers reside; or register for VAT through the special registration process for ESS in a single EU country of its choice. The company may then account for the VAT on all EU ESS supplies in a single return at the rate applicable in each country where its customers reside.<sup>6</sup>

Although these special rules for ESS currently only apply to supplies made by non-EU businesses, with effect from January 1, 2015, all suppliers (i.e. EU and non-EU businesses) of ESS will be required to account for VAT at the rate applicable in each country where their non-taxable customers reside.

### **Croatia and the five EU Candidate Countries**

There are currently five countries (Iceland, Macedonia, Montenegro, Serbia and Turkey) that are official candidates to join the EU. Croatia is an acceding country; meaning it will become the 28th Member State on July 1, 2013 subject to ratification of the Accession Treaty by all Member States. These countries will be required to comply with the EU VAT Directive once they join. However, some of these countries have already adopted new VAT rules for ESS.

#### **Croatia**

In Croatia there is no obligation to register or account for VAT where services delivered from the Cloud are supplied to a VAT-registered business by a non-resident supplier. Instead, the Croatian VAT-registered customer is required to self-account for the VAT due.

Croatia has amended its VAT legislation with effect from January 1, 2010 to ensure its rules are in line with the EU VAT rules. As such, non-resident suppliers of ESS to private individuals should technically register for VAT in Croatia. Practically, however, there are currently no set procedures for how non-residents with no presence in Croatia would go about registering for VAT in this case. Thus, although services delivered from the Cloud are, on the face of it, subject to VAT in Croatia, there appears to be no means for non-resident sellers to comply with their VAT obligations.

The standard VAT rate in Croatia is 25%.

#### **Iceland**

As of November 1, 2011, Iceland joined the group of countries that require non-residents to register and

account for VAT on services delivered via the Cloud to private individual customers not registered for VAT.

As such, non-resident businesses that supply ESS to non-VAT registered businesses with a fixed establishment in Iceland, or private individuals domiciled in Iceland, will be required to register and account for VAT through the appointment of a fiscal representative provided the registration threshold of ISK 1,000,000 (approx. US\$8,700) during a 12 month period is met.

The standard VAT rate in Iceland is 25.5%.

However, there is no VAT registration or accounting obligation for non-residents in relation to supplies of ESS to VAT registered businesses in Iceland. Instead, the VAT registered recipient is required to self-account for the VAT due.

#### **Macedonia**

Under the current rules, a non-resident business with no presence in Macedonia, supplying services delivered from the Cloud to individual customers in Macedonia, may, depending on the type of service supplied and whether the registration threshold of €32,500 (approx. US\$45,000) per calendar year is exceeded, need to register and account for VAT.

Services provided by a non-resident to a VAT registered business in Macedonia may also, depending on the type of service, be subject to VAT in Macedonia. However, the VAT-registered recipient would in this case be required to self-account for the VAT due, and the non-resident supplier should not have any VAT obligations in this case.

The standard VAT rate in Macedonia is 18%.

#### **Montenegro**

We understand that Montenegro intends to amend its VAT law during the 4th quarter of 2012 to ensure that it is in line with the EU VAT Directive. This will likely involve amendments to the current rules for determining whether a supply is subject to Montenegrin VAT.

Under the current rules, a non-resident with no presence in Montenegro, supplying services delivered from the Cloud to customers in Montenegro, may, depending on the type of service supplied and whether the €18,000 (approx. US\$25,000) registration threshold is exceeded, need to appoint a fiscal representative to account for the VAT due. However, if the customer is VAT registered, the VAT can be accounted for by the customer instead of by the supplier.

The standard VAT rate in Montenegro is 17%.

#### **Serbia**

In Serbia, supplies delivered from the Cloud are subject to Serbian VAT. If the recipient of the service is a VAT-registered business, it would have to self-account for the VAT due but should also be entitled to a credit of the same amount (assuming the recipient is a fully taxable business), leading to no cash flow cost.

If the recipient of the service is instead a private individual, that individual should account for and pay VAT to the Serbian tax authorities, but would not be entitled to a credit. This should be done by using the standard Serbian VAT return which can be found on the tax authorities' website. However, we understand that it is difficult for the Serbian tax authorities to determine whether a non-registered recipient would be obliged to remit VAT. In practice, most individuals therefore do

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not calculate or pay any output VAT to the Serbian tax authorities.

Non-resident entities without any presence in Serbia, such as a branch or similar, cannot register for Serbian VAT. Therefore, although services delivered from the Cloud are, on the face of it, subject to VAT in Serbia, no VAT compliance obligations currently exist for a non-resident seller.

The standard VAT rate in Serbia is 20%.

### Turkey

Under the current rules, supplies of services delivered from the Cloud by a non-resident entity to Turkish customers are subject to VAT in Turkey. If the supplier is not registered for VAT in Turkey, this VAT should be self-accounted by the recipient of the ESS.

Individuals are also required to self-account for Turkish VAT. However, this is not possible as there is currently no defined mechanism for them to declare and pay the VAT to the tax office.

Thus, although services delivered from the Cloud are, on the face of it, subject to VAT in Turkey, there appears to be no VAT compliance obligations for a non-resident seller.

The standard VAT rate in Turkey is 18%.

### Rest of the world

#### Norway

Norway amended its legislation with effect from July 1, 2011 to tax ESS supplies to private individuals in Norway. However, different from EU legislation, the Norwegian legislation requires, irrespective of contract language between a developer and a cloud based intermediary, that due to the intermediary being responsible for the electronic transmission of the

content, that the intermediary may be deemed to be the supplier of the ESS.

As such, a non-Norwegian business with no presence in Norway which is responsible for transmitting an ESS to an end customer in Norway is required to register and account for Norwegian VAT if supplies of services delivered from the Cloud to private individuals in Norway exceed NOK 50,000 (approx. US\$9,000) during a 12 month period.

The standard VAT rate in Norway is 25%.

#### Switzerland

Switzerland amended its VAT legislation with effect from January 1, 2010. VAT registration in Switzerland and accounting for Swiss VAT is required if annual ESS sales by a non-Swiss business to private individuals in Switzerland exceed CHF 100,000 (approx. US\$114,000).

VAT registration and accounting should generally be made as of the beginning of the business activity in Switzerland. If sales projected for the first 12 months are below CHF 100,000, the projection has to be re-evaluated after 3 months of business activity and at the end of a fiscal year. If the forecasted sales for the first 12 months exceed the CHF 100,000 threshold, the taxpayer can choose the commencement of the VAT registration and accounting to be either (a) the starting date of business activity, (b) the time of the re-evaluation or (c) the beginning of the 4th month of business activity.

For example, if a non-resident business begins selling ESS via the Cloud to Swiss private individuals in July 2012, it should register as of July 2012 if projected sales for the first 12 months exceed CHF 100,000. If the threshold is not expected to be exceeded, sales must again be forecasted at the end of September or

at the fiscal year end if earlier (e.g. August 31), for a full 12 months period. If the threshold still isn't expected to be exceeded, the next evaluation is due by the next fiscal year end. As soon as the projection shows sales above CHF 100,000, the VAT registration has to be made and VAT needs to be collected and accounted for.

#### Other countries

In the rest of the world, there are often no VAT compliance obligations for a non-resident seller of services delivered from the Cloud to private individuals or non-VAT registered businesses.

Most countries would only seek to impose VAT if the supplier is either established in their jurisdiction or where the relevant services are physically performed in their country. For services delivered from the Cloud, this second requirement would generally not be met, provided the relevant services are made from outside the particular country. This treatment is for example adopted in Australia, Mexico and New Zealand.

Other countries may seek to tax the services, but not by imposing an obligation on the non-resident supplier as it is often difficult to recover taxes collected by non-resident businesses. Instead, they shift the VAT obligation to the purchaser of the service by requiring the purchaser to account for the VAT due, in addition to the amount payable to the non-resident. However, in some countries, the purchaser would only have an obligation to account for VAT if it is VAT registered and/or is not entitled to fully recover any VAT incurred on purchases (for example because the recipient is a financial institution). Notably, New Zealand and Venezuela have adopted this treatment. We also understand that Japan is considering implementing similar provisions by 2014. Japan may also implement rules

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similar to those in the EU, Iceland, Norway, and Switzerland, effectively requiring non-resident suppliers of Cloud computing services to private individuals to register for and charge Japanese Consumption Tax on their services.<sup>7</sup> Further details regarding this proposal are expected soon.

Another group of countries require their residents to withhold the VAT from the payment to the non-resident supplier, meaning that the non-resident may end up with less cash in hand than envisaged. This regime is often hard to enforce by local tax authorities in practice, especially in the context of supplies to private individuals. In some countries, enforcement of the withholding is practically non-existent. However, this should not be assumed.

### **The takeaway**

The VAT treatment of services delivered via the Cloud continues to evolve around the world. As is evident from the preceding commentary, a greater number of governments are seeking to tax not only transactions within their territories but also

transactions where a resident individual or business in their territory is benefiting from the relevant service, irrespective of where the supplier is located.

As a non-resident supplier of services delivered from the Cloud, it is important to be aware that VAT accounting and registration obligations will arise where services are provided to private individuals and businesses not registered for VAT in:

- EU
- Iceland (provided the registration threshold is met)
- Norway (provided the registration threshold is met)
- Switzerland (provided the registration threshold is met).

Depending on the type of service provided, a supplier could also have VAT obligations in Macedonia and Montenegro, as well as Japan, as of 2014.

A supplier of Cloud computing services may not have any VAT accounting, registration or compliance obligations in the rest of the world. However, some countries may have regulations requiring the customer to withhold an amount from any payments made.

It would therefore be prudent for any provider of services delivered via the Cloud to seek professional VAT advice based on its particular circumstances before it enters a new market. Not doing so could have a significant impact on a seller's profit margin where it is later discovered that VAT should have applied and thus lead to hefty penalties and interest charges for non-compliance.

### **Let's talk**

For a deeper discussion of how this issue might affect your business, please contact:

#### **Value Added Tax (VAT) Services**

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## **Endnotes**

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<sup>1</sup> However, some jurisdictions, notably China and Taiwan, generally do not allow refunds of excess input tax credits. The excess credits are instead carried forward and offset against future VAT liabilities.

<sup>2</sup> Example: A US based company with no presence in the EU sells online games to a Swedish private individual for \$10. That sale is subject to 25% Swedish VAT, which is presumed to be included in the price. The US company will have to pay the VAT due to the revenue authorities out of the \$10 received, leaving revenue of only \$8 ( $\$8 \times 1.25 = \$10$ ), instead of the anticipated \$10.

<sup>3</sup> Article 14 of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (the VAT Directive).

<sup>4</sup> Article 24 of the VAT Directive.

<sup>5</sup> Article 7 of the Council Implementing Regulation (EU) No 282/2011 of 15 March 2011 laying down implementing measures for Directive 2006/112/EC on the common system of value added tax.

<sup>6</sup> US businesses most commonly choose to register in the UK or Ireland. For the applicable EU VAT rates, refer to the European Commission document summarizing this. The document is located at:

[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/vat/how\\_vat\\_works/rates/vat\\_rates\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/vat_rates_en.pdf)

<sup>7</sup> The current JCT rate is 5%, but is expected to increase to 8% from April 1, 2014, and to 10% from October 1, 2015.