

EU: Small change, big impact

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The start of 2015 will bring the biggest single change to EU VAT legislation that telecom operators, broadcasters and others that provide e-services have seen in decades. This article explores the change.

I. Background

The start of 2015 will bring the biggest single change to the EU VAT regime that telecom operators, broadcasters and others that provide e-services have seen in decades. The legislation is expected to have a profound impact on e-services providers, particularly on their pricing and commercial strategy. As providers of these services take steps to adapt to the new legislation, the result will be either a sharp increase in the prices charged to many consumers or a cut in suppliers' profit margins – neither of which is a desirable outcome.

An amendment has been made to the EU VAT Directive that's intended to harmonise the VAT treatment of the electronic service businesses' supply to consumers within the EU.¹ As it stands now, the legislation will predominantly affect telecoms operators, broadcasters and other e-services providers that sell directly to consumers (rather than business customers) who are based in the EU, irrespective of where the service provider itself is located.

In practice, companies based in the EU will be affected the most, as the rules change mostly for those suppliers. The changes will, however, affect non-EU suppliers – but to a lesser extent. The legislation is expected to have a profound impact on e-services providers, particularly on their pricing and commercial strategy.

While hard data on the size of the existing and potential markets is difficult to determine, two Member States (France and the UK) have indicated that for them the VAT revenue shift to their countries will be in the order of EU€400m per year at current levels of ac-

tivity. The impact of these VAT changes on businesses providing e-services is likely to be significant.

The legislation – effective January 1, 2015 – changes the place of supply and the country of taxation of business-to-consumer telecoms, broadcasting and “electronically supplied services” (as defined by tax law, more of which later) from the country in which the supplier is established to the country in which the consumer resides. This seemingly innocuous change will have a significant impact on operators and other e-services providers that have customers outside the territory they're located in: in particular those located in EU jurisdictions with favourable VAT rates.

Standard VAT rates across the EU currently range from 15 percent in Luxembourg to 27 percent in Hungary, with the range being even greater where reduced rates of VAT apply. The average standard VAT rate in the EU is currently around 21 percent. (See Figure 1)²

As far as EU legislators are concerned, changing the place of taxation to the location where e-services are consumed is long overdue. Technology and the ability to provide services across borders have made enormous progress over the last 20 years. And it's been clear that the EU VAT rules, which have their origin in the 1960s, have not been adapted to make sure that such e-services were effectively subject to VAT where consumption took place.

Businesses based in EU Member States have always been required (as they still are in 2013) to charge VAT on their e-services, but those based outside the EU, until July 2003, were not.³ The result was a disadvantage to EU-based providers, and, as a result, some chose to locate their sales operations outside the EU. This prompted the European Commission to persuade the Member States to change the rules and re-

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Figure 1: VAT rates applicable in EU Member States (as of July 1, 2013)

Member States	Super Reduced (percent)	Reduced rate (percent)	Standard Rate (percent)	Parking rate (percent)
Belgium	-	6 / 12	21	12
Bulgaria	-	9	20	-
Czech Republic	-	15	21	-
Denmark	-	-	25	-
Germany	-	7	19	-
Estonia	-	9	20	-
Greece	-	6.5 / 13	23	-
Spain	4	10	21	-
France	2.1	5.5 / 7	19.6	-
Croatia	-	5 / 10	25	-
Ireland	4.8	9 / 13.5	23	13.5
Italy	4	10	21	-
Cyprus	-	5 / 8	18	-
Latvia	-	12	21	-
Lithuania	-	5 / 9	21	-
Luxembourg	3	6 / 12	15	12
Hungary	-	5 / 18	27	-
Malta	-	5 / 7	18	-
Netherlands	-	6	21	-
Austria	-	10	20	12
Poland	-	5 / 8	23	-
Portugal	-	6 / 13	23	13
Romania	-	5 / 9	24	-
Slovenia	-	9.5	22	-
Slovakia	-	10	20	-
Finland	-	10 / 14	24	-
Sweden	-	6 / 12	25	-
United Kingdom	-	5	20	-

quire all non-EU e-services providers to charge their EU-established customers VAT at the rate applicable in the customer's own country, which was done from July 1, 2003. But the rule for the EU-based suppliers remained that of taxation where the EU-established provider had its establishment, regardless of the location of its EU customers. Again, a number of non-EU service providers adapted quickly to the change in legislation, with some choosing to locate in EU countries with low VAT rates.

So, currently, EU-based businesses providing business-to-consumer e-services charge VAT at the rate that applies in their home location (country of establishment), while non-EU providers apply multiple VAT rates based on the place where the customer is located or the service is used. The new legislation is designed to bring a consistent approach to taxing the provision of e-services to EU-established, non-VAT-registered consumers (which generally means private individuals, certain charities and public bodies).

From January 1, 2015, the provision of all e-services within the EU will be taxed in the customer's country,⁴ regardless of the location of the supplier. So, a US operator that sells mobile phone or broadband contracts to EU-based customers will be treated in exactly the same manner (from a VAT perspective) as a German

company, an Indian company or a French company. The main criterion that matters is the customer's location.

The VAT treatment for non-EU-established telecoms operators and other e-services providers that have EU customers but no EU establishments essentially won't change, except for the application of more precise rules, for example, in the determination of the location of the customer.⁵ Most affected by the change will be EU-established telecoms operators, broadcasters and other e-services providers that sell to customers located in other EU countries or which, due to the presence of land borders with other countries, also have a significant proportion of business-to-consumer customers situated outside the location where they are established.

The affected providers have been working with the Commission and Member States to put into place a legislative regime that's effective and efficient but that minimises the burdens on business. It's clear from the draft legislation that the Commission is aiming to strike that balance. Nonetheless, compliance will be a challenge throughout the affected sectors.

II. The details of the amended VAT legislation

Political agreement on the EU Implementing Regulation 282/2011, which introduces the changes, was reached at the end of June,⁶ however, it's clear that there are a number of grey areas. Many of them may be ironed out only as the legislation comes into effect through the use of Explanatory Notes which the European Commission are currently drafting and seeking input into from affected business – both in writing and through a Fiscalis seminar to be held in November.

The first, and most fundamental, question is: which e-services are caught by the new VAT legislation? The Implementing Regulation and the EU VAT Directive 2006/112/EC (as it effectively applies today to non-EU-established providers of e-services) address the question and state the current definition of e-services:

- Electronic services, i.e. paid-for services that are delivered over the internet or other electronic network, in a way that's essentially automated and that can't be delivered without information technology. Included are access to and downloading of screen-savers, ringtones, music, films, online games, e-books and online information such as traffic, news and weather reports, and subscriptions to digital newspapers or magazines. Software upgrades meet the definition, as do website hosting, banner blocking software, automated firewall installation, remote systems administration and online data warehousing. The category also includes fees charged to access software on the 'cloud'.
- Telecommunications, including fixed or mobile telephone services for voice or data, and VoIP services.
- Broadcasting, meaning radio or television programmes provided over a TV network or the internet.

Within the three main categories identified by the legislation – telecoms, broadcasting and other e-services – are many grey areas. For example, automated distance teaching that depends on the internet or a similar network and that requires limited or no human intervention would meet the definition of an e-service, and so would be taxed on the basis of the location of the pupil. But a virtual classroom where the internet is used simply as a tool for communication between student and teacher wouldn't meet the definition. The virtual classroom would be treated as a supply of an educational service (which doesn't fall under the e-services rules) and would normally be taxed on the basis of the place where the teacher is located.

The existing definition of an e-service remains largely unchanged, although the list of exceptions is getting longer.

III. Analysing the evidence: where's the customer?

The biggest challenge by far for telecoms operators and other e-services providers will be to determine, and prove, where each customer is based – because

the customer's location determines the applicable VAT (i.e. which country's VAT will be applied). The affected operators and other e-services providers have been working with the Commission and Member States on this area. As a result, some simplifications have been agreed for particular services, particularly in the field of providing evidence of the customer's location.

The legislation outlines the evidence that should be used to determine a customer's location for VAT purposes including a number of rebuttable presumptions that can be taken as evidence of a customer's location where specific services are supplied. Included are broadcasting, telecom and e-services supplied:

- to a telephone box or kiosk, Wi-Fi hotspot, internet cafe, restaurant, hotel lobby and similar locations where the physical presence of the recipient is required for the service to be rendered to him (in such cases, the physical location can be used as evidence of a customer's location)
- via a fixed landline where the physical place of installation of the landline can be used as evidence of a customer's location
- through mobile networks where the mobile country code of the SIM card can be used as evidence of a customer's location
- to a customer where a decoder or viewing card is needed, and where the decoder is located or the viewing card is sent can be used as evidence of a customer's location.

In cases where services are not covered by these specific services presumptions, two separate pieces of non-contradictory evidence (taken from a list suggested in the Regulation) will give a rebuttable presumption.

Should a supplier not wish to use one of the specific services presumptions, then he must obtain three pieces of non-contradictory evidence to determine where the customer is located. Tax administrations may rebut any presumptions made by a supplier (either using the specific services presumptions or those based on a number of pieces of non-contradictory evidence) without any specific evidential threshold, but only where there are indications of misuse or abuse by the supplier.

More work will be required before the legislation fully takes effect to make sure that businesses have sufficient certainty about the requirements being imposed on them.

Inevitably, cases will occur that have contradictory evidence about a customer's location or where there are questions as to whether services fall into the specific service presumptions contained within the legislation. For example, a Spaniard may rent a flat in Paris for the summer and buy a telephone service contract for a fixed landline for the duration. Whilst there he may purchase and download a piece of software from a German supplier which is supplied to him via his fixed landline, paying for it using his Spanish bank account and with the bill sent to his Spanish address. His address and bank account suggest that the Spanish VAT rate should apply, and yet the service is arguably one covered by the specific service presump-

tion for supplies made via fixed landlines. How businesses should assess cases such as these is still unclear, as is how tax authorities will approach them.

The guidance released so far suggests that the specific service presumption should be considered and applied first; however, it is unclear as to how wide these specific service presumptions should be interpreted. So, in our example, the German software provider should arguably look to the location of the fixed landline and charge French VAT. If the German supplier believes that the fixed landline presumption should not apply he could look to two pieces of non-contradictory evidence e.g. the Spanish bank account and billing address and charge Spanish VAT. As noted above, there's an element of legal uncertainty in this interpretation that could lead to the risk of either double taxation (i.e. both France and Spain claiming taxing rights) or non-taxation, so in order to obtain certainty the supplier would need to obtain three pieces of non-contradictory information from the customer. This would require the supplier to obtain an additional piece of information and to match it to the address and bank account details.

The main difficulties for affected providers are that current IT and billing systems generally aren't set up to cope with processing these multiple pieces of evidence. Creating new software to cross-check information is extremely complicated and expensive.

IV. Commercial considerations, multiplying issues

The change in the VAT legislation is by no means a narrow VAT issue – there are many potential knock-on effects that will need to be considered. The pricing, particularly of fixed-price contracts, will need to be re-assessed because EU-established e-services providers will have to apply a variety of VAT rates depending on the location of their EU customers. Any agreements with third parties that are based on consumer price (e.g. commissions for providing content) will also need to be re-examined.

In particular, providers that offer long-term services paid for by annual or monthly subscriptions need to be particularly aware, as the applicable VAT rate could change during the term of the contract. So, for example, if a UK-based business sells a two-year mobile phone contract to a customer in Hungary at the end of 2013 (i.e. the contract runs to the end of 2015), the VAT rate will increase from 20 percent (the UK supplier rate) to 27 percent (the customer's rate) during the life of the contract.

A further concern is that the suppliers' need – to ascertain the location of their customers – could erode hard-won customer loyalty. If the legislation requires operators and other e-services providers to ask more questions of their customers and to request more personal information, in order to secure the supplier's taxing position, the risk of damaging the consumer's experience is real. The data protection and other regulatory and security-related implications of collecting and storing information about customers (which may,

for example, include credit card information) will also have to be addressed – as those, also, are constantly evolving areas.

V. Compliance risks and a special scheme

From a purely administrative point of view, the legislation presents a considerable challenge for telecoms operators and other e-services providers. They'll have to determine where each customer is located and their tax status (are they registered for VAT or are they a final consumer?) and they must cope with multiple VAT rates. In theory, the changes also mean that from 2015 telecoms operators and other e-services providers could be obliged to file VAT returns in every EU country in which they have a customer. That would be an administrative nightmare.

As a result, the new legislation will extend a special scheme for VAT filings that's currently in place for non-EU-established providers of e-services.⁷ Under the simplified scheme (sometimes referred to as the MOSS scheme), EU suppliers of e-services can elect to register with the VAT authority of their 'country of identification', file a single VAT return detailing the supplies made to customers in the different countries and pay the tax due in those different countries. The tax authority of the state of identification will then be responsible for distributing the VAT due to each jurisdiction in which the customers are located. For many businesses, this could alleviate the burden of multiple VAT registrations, filings and payments.

The penalties that could be imposed on operators for non-compliance, though, could be high. Each Member State will have responsibility for policing VAT receipts, and domestic penalties will apply. The new legislation will allow EU Member States to push hard on compliance – they'll be entitled to, and will want to collect, the VAT that they're due.

The risk is that some Member States could take a particularly heavy-handed approach to the legislation. Many jurisdictions expect VAT receipts to increase sharply once the legislation comes into force. France has estimated the amount to be around EU€400m per year and to increase rapidly. If the increase fails to happen, many prominent operators and other e-services providers should expect an audit from the local tax authorities of the country of location of some customers.

Audits could well arise due to the enhanced systems of exchanges of information between the Member States. For example, Member State X might ask Member State Y what the total turnover of Company A is, and from the answer could decide that an audit of Company A is necessary because VAT revenues reported in Member State X don't match Member State X's expectation. It's worth noting that legislation is already in place requiring Member States to share spontaneously, or, upon request, information with other Member States about suppliers located in their country.

VI. Preparing to comply, cost-effectively

The new legislation will come as no surprise to the communications sector. Already, most businesses should be well ahead in their preparations. But we believe companies need to address a number of questions as quickly as possible:

- Are all departments within the business that will be affected aware of the legislation?
- What evidence will you use for determining a customer's location?
- Will you need to change your pricing structure and billing procedures?
- How should you adapt information technology and other systems?
- What's the best approach to compliance?

Operators that have a relatively small proportion of customers outside of their home location (which in practice is most likely to be UK- or US-based operators) have a number of options when it comes to compliance. One is to rely on manual cross-checking. For example, a UK-based operator could assume that for VAT purposes it could treat every customer as though the UK VAT rate applies, but could run a report every month looking for non-UK addresses and then process the results manually. That pragmatic approach pays attention to practical considerations and could be the most sensible and most cost-effective solution. To invest significantly in upgrading systems when the amended legislation might affect only a small proportion of customers would be counterintuitive.

The best solution will be organisation-specific and will require a thoughtful assessment of the information that's needed, measured against the systems changes that are required.

VII. Wider strategic issues: rethinking business strategies?

In the longer term, the new EU VAT regime raises another question for the many telecoms operators and other e-services providers that have been attracted to certain EU jurisdictions also because of the lower VAT rates in those countries. The new rules mean that the VAT rate in the country of the supplier is no longer relevant. That change might trigger some companies to rethink their European business strategy and revisit their choice of global or European hub. A change to the VAT regime has transformed the sector in the past – we'll be watching carefully to see if history repeats itself.

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NOTES

¹ Council Directive 2008/8/EC.

² Source: http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/rates/index_en.htm.

³ Council Directive 2002/38/EC.

⁴ Council Directive 2008/8/EC.

⁵ Draft Regulation adopted by the ECOFIN June 3013 – not yet published in the OJ - original draft COM(2012) 763 final.

⁶ Draft Regulation adopted by the ECOFIN June 3013 – not yet published in the OJ - original draft COM(2012) 763 final.

⁷ Council Regulation 904/2010.

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