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VAT ON E-SERVICES: HOW NEW RULES AFFECT BUSINESSES

Literature reviews

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Abstract

From 1st January 2015, in the European Unionwill enter into force a new VAT regime for business-to-consumer suppliers of telecoms, broadcasting and electronic services. This regime will have an impact on businesses engaged in the supply of certain products and services over the Internet. This article is a literature review. It is aimed to provide an analysis of the European VAT regime applicable to electronic services and clarify some key issues like: what are e-services, what are the changes and how the businesses are affected by these new rules. The paper also approaches issues such as: the change of the rules regarding VAT place of supplying and the introduction of the VAT Mini One Stop Shop (MOSS). The main conclusion is that the change in the place of supplying rules will serve to negate the VAT advantages associated with Internet companies which locate their invoicing functions in a Member State that is different from where they locate their substantial activities.

1. Introduction

Starting with 1st January 2015, a new VAT regime will be applied in the EU which will directly affect business-to-consumer telecommunications, broadcasting and electronic services providers.This new WAT regime will significantly affect corporations involved in providing certain services on the Internet, in supplying certain products (software), or in providing services on smartphones or other distribution channels. The new regulations will provide the opportunity to streng then the distribution and operational structures of the European tax system, to eliminate system complexity and to reduce costs. These new rules will also enable companies to rationalize their costs.

This article is a literature review and it approaches the VAT on e-services issue and the impact of the new rules on the EU businesses.

The paper is structured into five parts, in which the following questions are approached: e-services in terms of current legislation, the current EU VAT regime on e-services, the new rules thatwill come into force on1st January2015 and their effects on EU businesses, whilethe last part contains the main conclusions of this study.

2. E-services

Before addressing the VAT matter,it is necessaryto clarifythe notion ofelectronic services.

As a consequence of usingIT,computers andnetworks, we witness the dematerializationof goods andtheir transformation intovirtual goods. In other words, certain goods which until nowcould beprovidedonly in person,can now betransferred through the Internetandthus become a competitive substitute on the global market (Parrilli, D.M. 2008, 91).

A good exampleof the phenomenon ofdematerializationof goods, is represented bynewspapers. At present, in order to readnewsonline, everyone downloadstheir*pdf*format.In termsofVAT,the printedversionof a newspaperrepresented a merchandise, while the online version, with exactlythe same content, is considered to bea service.

Another example ofdematerializationof goodsisinformation storagecapacity.In this field, the monopoly of physical devices is challenged by the provision of Internet-based services, so that many companies prefer to buy extra capacity on-line instead of acquiring expensive physical machines.

The concept ofe-services, i.e. theprovision ofelectronic services,is notclearly definedinthe European legislation, but according to the VATDirective (Council Directive 2006/112/EC), it includes:

- website supply, web-hosting, distance maintenance of programs and equipment;
- supply of software and updating thereof;
- supply of images, text and information and making databases available;
- supply of music, films and gambling games, and of political, cultural, artistic, sporting, scientific and entertainment broadcasts and events;
- supply of distance education.

Even if this list is quite clear, it can be problematic to assess when a service is expected to be an e-service. To be more precise, the supply of software is deemed to be an e-service, but the Directive does not specify how the supply should take place: only over the Internet, or also over other networks, or through other delivery systems.

This problem isclarifiedin part by Regulation1777/2005(EC), which in Article 9provides a comprehensive definition of e-services: they shall include services which are delivered over the Internet or over an electronic network;by their nature they render their supply essentially automated and involve minimal human intervention; in the absence of

information technology it is impossible to deliver such services.
The listof electronic servicesdeliveredover the Internet orotherelectronic network, provided by Article9 of the Regulation No1777/2005,includes:

- The supply of digitized products, including software and changes to or upgrades of the software;
- Services providing or supporting a business or a natural person on an electronic network, such as a website or a webpage;
- Services automatically generated from a computer via Internet or an electronic network, in response to specific data input by the recipient;
- The transfer for considering the right to upload goods or services for sale on an Internet site operating as an online market on which potential buyers make their bids by an automatic procedure and on which the parties are notified of a sale by electronic mail automatically generated from a computer;
- Internet Service Package (ISP) of information in which the telecommunications component forms an ancillary and subordinate part (i.e. packages going beyond mere Internet access and including other elements such as: content pages giving access to news, weather or travel reports; playgrounds; website hosting; access to online debates, etc.).

InthisRegulation,all services listed in AnnexIIoftheSixth Directive (Council Directive 2006/112/EC), mentioned above, are provided as well.
Concludingwhat we have mentioned above, itcan be saidthat, inaccordance withthe European legislation, electronic services refer tothose services whichareautomatically provided,withoutanyhumaninvolvement.

3. Current EU VAT Regime applicable to e-services

The European legislationin forceuntil December 31st, 2014in thefield of VATon electronic servicesis Council Directive2006/112/ECamendedbyCouncil Directive2008/38/ECregardingthe place of services supply.
For economic reasons, some of the amendments of the last Directive mentioned abovewill come into force starting with 1stJanuary2015.
First, it isimportantto establishand define some keyconcepts,like:

- *Non-established taxable person*, which pursuant to Article 358 from 2006/112/EC Directive, means a taxable person who has not established their business on the territory of the Community and who has no fixed establishment there.
- *Member State of identification*,pursuant to the legislation, means the Member State which the non-established taxable person chooses to contact when their activity as a taxable person within the territory of the Community begins, in accordance with the provisions of the current legislation.
- *Member State of consumption*, means the Member State in which the supply of e-services is deemed to take place.

In the following, fora better understandingof the legislation,this articleapproachessome practical and specific situations, such as:
EU-established supplier and EU-established customer. In this case, it is necessary to separate business-to-business (B2B) from business-to-consumer (B2C) transactions, provided that the relevant sets of rules are radically different (Pastukhow, O., 2007, 55). Thus,in the former case, the

VAT Directive (Council Directive 2006/112/EC) will be applicable, and therefore the place of supply of e-services to customers established outside the Community, or to taxable persons established in the Community but not in the same country as the supplier, shall be the place where the customer has established their business or has a fixed establishment for which the service is supplied, or, in the absence of such a place, the place where they have their permanent address or usually resides. A taxable person is, pursuant to Article 9 of the VAT Directive (Council Directive 2006/112/EC), any person who, independently, carries out any economic activity, in any place,whatever the purpose or results of that activity. For example, if a company A located in a Member State sells online software and solutions to B, a business established in another Member State, the place of supply is deemed to be the Memeber State wherecompany B is located, and therefore the place of taxation will be the Member State of company B, according to Article 63 of the VAT Directive, which states that a chargeable event shall occur and VAT shall become chargeable when the goods or the services are supplied. The situation is different in the case of a B2C transaction, regulated by the Article 43, and therefore the place of supply and taxation will be the country of the supplier. For instance, if company Asells online music or videos to a private consumer, B, who lives in another Member State, the place of taxation will be the Member State where Company A is located.

EU-established supplier and non EU-established customer. The application of Article 56 of VAT Directive implies that the place of taxation in the case of supply of services to customers located outside the EU is the place where the customer is established, therefore EU suppliers are no longer compelled to levy VAT when selling on markets outside the EU. Provided that VAT, pursuant to Article 2 of the VAT Directive, is levied only for supplies of services under consideration within the territory of a Member State, by a taxable person acting as such, no VAT will be charged for these transactions. Therefore, if company A, located in a Member State, sells online capacity to customers located outside the EU, no VAT will be imposed.

Non EU-established supplier and EU-established customer.The field of supplies of e-services from non-EU countries to consumers established in the EU was reformed in 2002, primarily by Directive 2002/38/EC. Provided that EU suppliers previously had to levy VAT on the provision of their services worldwide, while non-EU suppliers were not compelled to do so in case of services supplied to European customers; the consequence was a tremendous competitive advantage to non-EU suppliers that could deliver goods electronically VAT free, while their competitors had to charge VAT when they supplied final consumers in the EU and elsewhere. For example, European exporters to the United States had to pay EU VAT, while American exporters were not under a similar obligation. The final results were both competitive disadvantage for European companies and distortions in the internal market.

4. Future development in the EU VAT Regime and its impact on businesses

VAT ratethat currently appliesis determined bythe place ofsupplyrules.

The placeof deliveryofgoodsisgenerallythe placewhere the goodsarelocated at the time ofthe provision. For services, itisa little more complicatedto establishthe place of supply.

For business-to-consumer supplies of services of telecoms, broadcasting and electronic services, the current place of supply rules, which will be changed on 1st January 2015, provide that the VAT to be applied is the VAT of the supplier’s home Member State regardless of the end place

of supply. It isimportant to be noted that different countries in Europe have different VAT rates and this fact is a relevant factor in determining the country where traders are established to deliver e-services.

Companies candevelop aplanto enable themto establish theirmain activityin anEU Member Statein which alowertaxrateapplies. Inthe currentVATregime, the commonpracticefor B2C Internet companies is to locate substantial trading activities in a lower tax rate Member Stateand so to benefit from the numerous advantages available and at the same time, to route their supplies through a company located in another Member State that applies the lowest permissible VAT rate of 15%. This means that, despite the fact that no substantial activity may be carried on in this Member State, the VAT rate applied is 15% (i.e. maximum revenue is retained)(European Commission, 2013, *Taxation trends in the European Union*, p.33).

A package ofamendmentstothe EU VATsystemwas adoptedbythe EU Finance MinistersinFebruary 2008. It is aboutthe Council Directive 2008/38/EC of 12th February 2008 which modify the Council Directive 2006/112/EC as regards the place of supply of services.

From 1st January 2015, the place of supply of business-to-consumersupplies of telecoms, electronically supplied services and radio and television broadcasting within the EU will be the country where the customer is established or usually resides and not the country from where the service was supplied. Therefore, in the case of these supplies, there will be no particular VAT benefit from locating invoicing functions in a low VAT jurisdiction, as the VAT rate will be variable in accordance with the place of residence of the customer who received the services.

Under these new rules, EU suppliers are no longer forced to levy VAT when selling on markets outside the EU, thereby removing a significant competitive handicap. Previously, under the tax rules drawn up before, EU suppliers had to charge VAT when supplying digital products even in countries outside the EU.

These changes eliminate an existing competitive distortion by compelling non-EU suppliers to charge VAT as EU suppliers when they provide electronic services to EU non taxable persons, something which EU businesses had been actively seeking for some time.

These rules are mandatory for any kind of e-business, no matter where it is established or has a nexus: in the EU, the USA, China, India, Australia, or Switzerland. As soon as a company provides e-services to a non VAT registered EU customer (regardless whether the customer is a legal or a natural person), it is bound by these rules, regardless whether it has a “physical” presence, server or agent in the EU. The customer’s location is the only thing that matters.

The most important change happens to e-businesses located within the EU that sell their e-services to business-to-consumer customers, that are also located in the EU (business-to-consumer customers include besides private consumers, also various non-VAT registered businesses, governmental organizations and other legal persons).

The new VAT rules abolish the distinction between EU and Non-EU companies which provide their eservices to EU business-to-consumer customers.

For abetter understanding ofthe new regulations,the current andfutureregulationsandtheir effectson businesses will be further presented.

Pursuant to current rules:

<u>Supplies into or from the EU</u>

- If e-services are supplied outside the EU to a customer in the EU, or inside the EU to a customer outside the EU, VAT is payable in the country where thatcustomer

resides (has their main business or fixed premises, their permanent address or usually lives there).

The effects of this are as follows:

- In the case of an EU business supplying tobusiness or consumer outside the EU, usually no EU VAT is charged, pursuant to Articles 44 and 59of the VAT Directive. But if services are effectively used in an EU country, that Member State can decide to levy VAT (pursuant to Article 59ofthe VAT Directive).

For instance, a company located in a Member State sells an anti-virus program to be downloaded through its website to businesses or private individuals in a non-EU Member State. There is no charge for the Member State or other EU VAT on this service.

- Non-EU businesses supplying to:(1)Businesses located in the EU,no VAT is charged in this case, pursuant to Article 44 of VAT Directive. The customer must account for the tax. This is the reverse-charge mechanism.
- (2) Consumer established in the EU. In that case VAT must be charged in the EU country where that consumer resides (is registered, has their permanent address or usually lives), pursuant to Article 58 of the VAT Directive.

For instance, a private person living in an EU Member State uses a Japanese online library. The Japanese supplier must charge EU Member State VAT (http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/telecom/index_en.htm).

Mini one-stop shop – MOSS

Non-EU firms supplying electronic services to consumers in the EU can make use of a simplified procedure which allows them to register for VAT in just one EU country, regardless of how many other EU countries they supply.

That country collects and distributes the VAT on behalf of all the other countries – charged at the applicable national rate depending on where the customer resides. This rule does not currently apply to telecommunications or broadcasting services.

Supplies between EU countries

- For business-to-business transactions, VAT is payable in the country where the customer resides.
- For business to consumer transactions, VAT is payable in the EU country where the supplier resides.

The *effects* for EU businesses are:

- when supplying a business in another EU country, they must *not* charge VAT; the customer must account for the tax under the reverse-charge mechanism, pursuant to Article 44of the VAT Directive;
- when supplying a consumer in the EU, they *must* charge VAT in the EU country where the business is based, no matter where the customer resides, pursuant of Article 45of the VAT Directive.

Pursuant to the new rules which enter into force on 1st January 2015:whether customer is a business or consumer, whether supplier is based in the EU or outside it, they will always be taxed in the country where the customer resides.

The meaning of these new rules for a business (taxable person) isthat, either the country where that business is registered or the country where it has fixed premises and which receives the service, the business will always be taxed in the country where the customer resides. Consumers (non-taxable person) will be charged in the country where they are registered, have their permanent address or usually live.

The effects of this are as follows:

For EU businesses supplying:

- Business in another EU country – will notbe VAT charged. Customer must account for the tax (reverse-charge mechanism).
- Consumer in another EU country - VAT must be charged in the EU country where the customer resides (not where business is based).
- Business or consumer outside the EU - there will be no VAT charged

For non-EU businesses supplying:

- Business in the EU – there will be no VAT charged. Customer must account for the tax (reverse-charge mechanism).
- Consumer in the EU – in that case VAT must be charged in the EU country where the customer resides.

From 2015, the one-time registration scheme (*Mini-one-stop-shop*) will be extended to telecommunications and broadcasting services and will be available for EU businesses, too. Starting with 1st January 2015, from supplies to consumers, both EU and non-EU businesses can use a web portal in the EU country where they are VAT-registered to declare and pay the VAT due in their customers' EU country.

In other words, regardlessof where services are supplied, the VAT rateto be applied,will be thatof the State ofresidence of theconsumer.

This way, legal tax evasion will be fought against and Mini-one-stop-shop will simplify the VAT procedure.

5. Conclusions

There are significant benefits in locating both substantive, and invoicing functions in one jurisdiction in order to minimise the costs associated with maintaining presence in several countries.

Changingthe place ofsupplyrulesserve toremovethe advantages of VATowed bycompaniesthat provideelectronic services, and thatset theirdelivery placein aMember Stateother thanthe one in whichthey have the main activity. In other words, these new rules will fight against the harmful tax competition which currently manifests through legal tax evasion.

In addition, when the new rules on place of supply for electronic services will come into force, the VAT rate to be applied will be that of the State of residence of the consumer. This willencouragecompaniesto establishboth thebasic activityandthe invoicing function inthe sameMember State and will reduce costs for businesses; at the same time, the new rules will allow the streamlining of corporate structures and certainly businesses should consider this in their planning.

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