

TAXREP 67/07

VAT - OPTIONAL REVERSE CHARGE MECHANISM

A submission made on 15 October 2007 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to a consultation paper issued on 14 August 2007 by the European Commission

CONTENTS

	Paragraph
Introduction	1-4
Key point summary	5-6
General comments	7-16
Detailed comments	17-46
	Annex
Who we are	A
Ten Tenets for a Better Tax System	B

ICAEW Tax Faculty, Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ www.icaew.com/taxfac	T	+44 (0)20 7920 8646
	F	+44 (0)20 7920 8780
	E	tdtf@icaew.com

VAT – OPTIONAL REVERSE CHARGE MECHANISM

INTRODUCTION

1. We are pleased to respond to the consultation paper issued by the European commission on 14 August 2007 regarding an optional reverse charge mechanism, which can be found at http://ec.europa.eu/taxation_customs/common/consultations/tax/article_4209_en.htm
2. The European Commission is seeking views on the possible introduction of an optional reverse charge mechanism. The consultation is based on a study by PwC assessing the expected impact of such an option on businesses.
3. Details about the Tax Faculty and the Institute of Chartered Accountants in England and Wales are set out in Annex A and our Ten Tenets for a Better Tax System which we use as a benchmark is in Annex B. The technical tax work of the ICAEW is handled by committees covering the various taxes, supported by a professional secretariat. Members of committees are volunteers working largely in practice (in professional firms of advisors) and industry, thereby providing a wide cross-section of experience in both large and small firms.
4. The ICAEW does not itself engage in transactions with other EU Member States to the extent that it would be affected by the options under discussion. It is therefore unable to respond to the request for transactional data.

KEY POINT SUMMARY

5. An optional reverse charge will be very expensive for business to set up and operate, will add no value to the business itself, and will increase the VAT risk of selling in the domestic market. As a result, it is likely to distort business behaviour as businesses restructure their operations to minimise these costs and risks. Any such restructuring is likely to work against the concept of a Single Market.
6. The only effective way to counter the type of fraud that an optional reverse charge is intended to defeat is to remove the opportunity to commit it. This can only be achieved by charging VAT on cross-border supplies of goods and services. A domestic reverse charge is not the answer

GENERAL COMMENTS

7. The Commission Consultation Paper starts with the paragraph

‘The European Commission considers the effective functioning of the internal market to be a cornerstone to its Growth and Jobs Strategy as it is important for the achievement of increased efficiency and competitiveness for EU businesses. Taxation policies can contribute to these objectives, notably through combating tax fraud that creates a significant distortion in the functioning of the internal market, prevents fair competition and also erodes revenues that should be used for the implementation of public services at national level.’

8. We would agree with the sentiments, but are very concerned that a domestic reverse charge will in fact have precisely the opposite effect for growth and jobs, since there is a high probability that businesses will restructure their operations in other countries in order to avoid the additional costs and risks. There is no data available to quantify the risk to growth and jobs within the EC, but when it is possible to do so it will be too late - businesses will already have moved their operations outside the member state concerned, or even outside the EC.
9. It is most important that any changes introduced to combat fraud should be clear and simple to operate. Otherwise, legitimate businesses are likely to be penalised for innocent errors. We believe that the introduction of an optional system of taxation will inevitably lead to complications, resulting in errors, deliberate or otherwise.
10. Any new administrative burdens on legitimate businesses should only be imposed if absolutely essential to combat fraud.
11. If the rules are not consistent across all EU Member States, it is almost certain that confusion, complications and errors will occur. The associated risk of being penalised for errors is likely to result in some businesses deciding to cease with cross border operations, or at least with countries that implement the option.
12. Both scenarios considered in the PwC study create additional administrative burdens on business, which in some cases are considerable. In particular, we believe that the second scenario could lead to significant accounting difficulties. For example, the VAT invoicing treatment would change in the middle of each month between two companies engaging in regular transactions below the threshold, but having a total monthly value of transactions above the threshold.
13. It is unreasonable to expect businesses to supply information more frequently than once per month. If a threshold based on an individual invoice were to be adopted, we believe that it should not be necessary to provide a report more than once per month. Any monthly report should include the date of each invoice and be capable of submission in accordance with any internal accounting periods that may be operated by the business making the submission.
14. We believe that the introduction of an optional reverse charge mechanism would create a considerable risk of fraudsters being able to obtain goods without paying VAT. This could be achieved by the fraudsters convincing a legitimate but less astute business that they were purchasing goods for legitimate business purposes. The legitimate business would then sell the goods without the addition of VAT on the false expectation that the fraudsters would account for the reverse charge.
15. In brief, we consider that the only effective way to counter this type of fraud is to remove the opportunity by charging VAT on cross-border supplies of goods and services. We do not consider that a domestic reverse charge is the answer.
16. An optional reverse charge will be very expensive for business to set up and operate, will add no value to the business itself, and will increase the VAT risk of selling in the domestic market. As a result, it is likely to distort business behaviour as businesses restructure their operations to minimise these costs and risks. Any such restructuring is likely to work against the concept of a Single Market.

DETAILED COMMENTS

Background

17. The background to this Consultation is the increase in carousel fraud, and the need for Member States to take further action to counter it. The issue has been the subject of two recent Reports from the UK Parliament:
- the House of Commons Committee of Public Accounts *Standard Report on the Accounts of HM Revenue and Customs: VAT Missing Trader Fraud Forty-fifth Report of Session 2006–07*, published on 9 July 2007;
 - and the House of Lords European Union Committee *20th Report of Session 2006–07, Stopping the Carousel: Missing Trader Fraud in the EU*, published on 25 May 2007.
18. In addition to our giving evidence to the UK Parliament, we also set out our views on how this should best be done in our 26 March 2007 submission to the Commission (please see TAXREP 29/07, *VAT: Closing the Gap, A business perspective on methods of charging VAT cross-border to end carousel fraud* – <http://www.icaew.com/index.cfm?route=146631>).

Administrative Costs

19. The requirement to obtain and verify a special reverse charge VAT number for all sales could be a greater administrative burden to all affected businesses than envisaged in the PwC report and should not be necessary. Verification of overseas VAT registration numbers to meet existing invoicing requirements can prove burdensome and should be sufficient, without the need for a second similar verification procedure.
20. The impact of any change could be reduced if businesses had the option to adopt consistent treatment for all of its sales, regardless of the amount or status of its customer.
21. It is important to understand the extent of the changes a business will need to make to its IT systems, VAT accounting systems and if a domestic reverse charge is introduced in a Member State.
22. It is not possible for the ICAEW to give examples of specific costings, although we have heard of provisional estimates from large businesses that could run into tens of millions of Euros. Much would depend on the precise rules which are legislated in a member state and on the IT cycle of the company involved - ie the extent of spare capacity in the existing IT systems and how much new hardware would need to be acquired.
23. The 20 June 2007 PwC Study for the Commission took a sample of 20 companies and considered the impact of a domestic reverse charge. Taking Appendix 3 of the PwC Study as an example, the actions required by business can be summarised as follows:

	Actions Required	
Sales		
Quotation	12	
Confirm Orders	8	
Invoice Customer	18	
Process Accounts Receivable & manage collections	9	
Manage/Process Adjustments & Bonuses/Discounts	<u>12</u>	59
Purchasing		
Select Suppliers & Develop Contracts	11	
Order & Receive Goods & Services	8	
Process Accounts Payable	<u>13</u>	32
Comply with VAT Obligations		
Register for VAT reverse charge	2	
File purchase & sales listing	10	
File periodic VAT Returns	10	
Communication with tax authorities	<u>3</u>	25
Total actions required		<u>116</u>

24. It is important to appreciate that none of these changes add a single Euro of value to the business - they would be required by a member state purely for tax compliance reasons. As the PWC Study states, some of these actions are 'one-off', others are recurring.
25. The training of junior sales and purchase ledger staff to ensure the correct VAT treatment on the processing of invoices could be problematic.
26. As a general rule, any adjustments to transactions by the issue of credit or debit notes should be given the same treatment as the original invoice to which they relate. Under no circumstances should the VAT treatment of the original invoice have to be changed as the consequence of an adjustment in value.
27. A business needing to comply will have to consider the IT investment required and how this can be achieved. The internal tax department will have to 'bid' for that time against other competing claims (which would add value to the business). Senior management may have to delay these value-adding IT improvements in order to comply with the new VAT requirements.
28. The obvious question will then be asked: 'Can the business restructure its operations in order to avoid or reduce these additional costs?' In many cases, the answer will be 'Yes'. We consider this further in the section, *Impact on Cross-border Competitiveness* below.

Increased Risk for Business

29. We are seeing an unfortunate and increasing trend for tax authorities to transfer their costs and risks to business, and then to seek to recover any VAT lost from another business in the chain of supply, whether or not that other business had any knowledge of their customer's actions. There have been a number of European Court of Justice judgments court cases in this area, most recently in *Teleos*, (Case C-409/04, judgment of 27 September 2007).
30. The Commission's Consultation paper does not consider in detail the increased risk for business inherent in any domestic reverse charge. Whilst, when the details were known, it would be possible for a business to calculate the additional compliance and administrative costs, it would be difficult if not impossible for them to calculate the cost of the additional risk if their customer did not account properly for the reverse charge VAT due and the tax authority seeks to recover that VAT from them.
31. In many cases, it would not be cost-effective for a company to challenge a tax authority through the courts. As a result, companies would become increasingly reluctant to take on new and unknown customers where the reverse charge would apply, particularly if the value of expected sales will not be that great. This would have an adverse effect on new businesses seeking to enter the market, which may well be forced to acquire their goods and services from more than one source (so that all the supplies to them are below the reverse charge threshold).

Cash Flow Impact

32. A domestic reverse charge would have different cash flow impacts on different businesses. For some businesses there would be a positive impact, for some negative, depending on the terms of trade of the business. Even businesses in the same sector would see different cash flow effects.
33. Broadly, we would expect a domestic reverse charge to benefit larger businesses at the expense of smaller ones. Large businesses would tend not to pay VAT on their purchases, and would not charge VAT on their supplies, since both would be above the threshold. For them, VAT would be neutral in cash flow terms. The biggest 'winners' could well be large retail chains, since they would purchase 'VAT-free' above the threshold, but sell below the threshold for immediate cash payment, including the VAT charged.
34. If a large business withdrew from selling in that domestic market, it would still not charge VAT on its sales, since these would become intra-EC supplies (or imports by the customer).
35. Smaller businesses would tend to pay VAT on their purchases and charge VAT on their sales. But in every case, it would be a question of how companies managed their VAT debtors and creditors.

Impact on Cross-border Competitiveness

36. This will depend very much on how many businesses restructure their operations within the EC. Over time, we would expect to see extensive restructuring and some

businesses to withdraw from selling directly in those member states which operated a domestic reverse charge.

37. One particular risk we see is that businesses will cease trading within the EC by supplying instead from a third country, leaving it to their customers to deal with the import. This would be an attractive and relatively simple option for SMEs who sourced their goods from outside the EC. They would simply need to set up a company outside the EC which would make all the supplies directly to their EC customers. The same process could be used if the risks of trading cross-border within the EC were to be increased by an extension of the joint and several liability provisions.

Businesses operating in a Member State with a domestic reverse charge

38. Because of their size, MNCs (Multi-national corporations) have considerable power to set the conditions to trade with their customers in the marketplace. Looking purely at the VAT issues, and not taking into account any other more general legal requirements, possible restructuring for an MNC operating in a member state which introduced the domestic reverse charge could include:
- Withdrawing from selling goods domestically in that country, and only supply customers from another Member State or from a third country.
 - Only selling domestically to a limited number of 'approved' customers in a member state at levels always in excess of the threshold, so that the reverse charge would apply. By making no sales below the threshold, the MNC would avoid the need for a two-rate VAT accounting system. Smaller businesses would then need to source their goods from a wholesaler. Adding a further business into the supply chain would increase the cost of goods for the smaller business, and thus to the final consumer.
 - Charging new customers a 'approved customer joining fee' for the additional costs and risks when setting up a new customer account.
 - Requiring, as a condition of making a sale, customers to provide a long-term guarantee from a third party such as a bank for the VAT element of their purchases to protect the MNC from any claim by the tax authority if VAT were lost. Since banks include the amount of any guarantees in the overall credit they are prepared to give to any business, this would reduce the amount available for the customer to borrow to finance or expand.
39. SMEs (Small and Medium size Enterprises) have less opportunity to dictate terms in the market place, but could:
- Refuse to make sales over the threshold, and so always charge VAT on the supply. This would also avoid the need for a two-rate VAT accounting system. It is possible that, where a customer wished to make a purchase over the threshold, some businesses would consider making them via a third party.
40. Every business will look for its own optimal solution, and there may well be other possibilities. In any event, the domestic reverse charge would be likely to have a negative effect on both business efficiency and economic growth. In addition, the extra costs will inevitably flow through to the prices charged to final consumers.

Businesses operating in a Member State without a domestic reverse charge

41. These businesses will be able to continue to supply goods and some services to customers in the Member State with the reverse charge. However, where the costs would be substantial, and taking into account the additional VAT risks, they may be unwilling to set up operations in a member state which operates the domestic reverse charge. A high entry cost for new businesses in that member state could therefore be expected to reduce competition.

Businesses operating in Member States, some of which have a domestic reverse charge and some not

42. We would expect that such businesses would first review the additional costs and VAT risks of their operations in those member states with a domestic reverse charge. As a result, they might decide to withdraw from making sales directly in those markets, and 'retreat' to making intra-EC sales from another member state.

Experience of the Limited Reverse Charge in the UK

43. On 16 April 2007, the UK obtained the derogation for a limited domestic reverse charge, and this was brought into UK law with effect from 1 June 2007. It is clear that insufficient time was allowed for implementation. A number of large businesses were unable to adapt their VAT accounting systems in time, and so now apply the reverse charge to all their supplies to VAT registered businesses, whether the value is above or below the £5000 UK threshold. HMRC (Her Majesty's Revenue & Customs) are well aware of this practice, and we understand have agreed to it in some cases.
44. As a matter of law, we consider that, where the value of the supply is below £5000, the purchaser is not required to apply the reverse charge, but the practice has caused understandable confusion for purchasers.
45. It is essential that any Member State wishing to introduce a domestic reverse charge does not follow the UK approach, but rather allows business sufficient time to adapt their VAT and IT systems.
46. We commented in more detail on the UK reverse charge provisions and problem areas in our TAXREP 33/07, available from our website www.icaew.com/index.cfm?route=148207.

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15.10.07

ANNEX A

WHO WE ARE

1. The Institute of Chartered Accountants in England & Wales is a professional body representing some 128,000 members. The Institute operates under a Royal Charter with an obligation to act in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy (which includes taxation).
2. The Tax Faculty is the centre for excellence and an authoritative voice for the Institute on taxation matters. It is responsible for tax representations on behalf of the Institute as a whole and it also provides services to more than 11,000 Faculty members who pay an additional subscription.
3. Further information is available on the ICAEW website, www.icaew.com, and on the ICAEW Tax Faculty website at www.icaew.com/taxfac or telephone +44 (0)20 7920 8646.

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 - see <http://www.icaew.co.uk/index.cfm?route=128518>.