INTERNATIONAL VAT UPDATE

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THE POWER OF BEING UNDERSTOOD
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EU

United Kingdom invokes Article 50 and commences 'Brexit' negotiations

The United Kingdom has now notified the EU Commission of its intention to leave the European Union under Article 50 of the Treaty of Lisbon, thereby commencing a two year period of negotiation as to the terms if its departure and discussions as to the possible nature of a future trading partnership.

The UK Government has already started on the practical steps required for life outside the EU by publishing the 'Great Repeal Bill' White Paper – in order to bring 44 years' worth of EU case law and directives onto the UK statute book, in time for Britain's exit from the EU in March 2019. Whatever the outcome of the Brexit discussions we do know already that indirect taxes (namely VAT and customs duty) will be the most significantly impacted, given their fundamental EU origins, so perhaps not unexpectedly the Great Repeal Bill makes comment about how the UK's indirect tax system will transition into the post-Brexit UK.

In the context of VAT, while the CJEU will no longer have any jurisdiction in existing United Kingdom VAT law (or any new VAT laws), post-Brexit, the Bill will ensure that historic CJEU case law, as it stands on the day of secession from the EU, will have the same binding, or precedent, status as if it were a decision of the Supreme Court in the UK, so as to avoid cresting new uncertainties about the application of VAT to UK businesses. CJEU case law has fundamentally shaped the UK's VAT system, and so it would not make sense for this to be ignored once the UK has formally left the EU.

Customs duty, on the other hand, potentially presents further more practical challenges given the expected rise in customs declarations to around 300m per year once the UK leaves the customs union (from its current level of 60m). Duty legislation emanates directly from EU law and so primary legislation subject to Parliamentary scrutiny will required to put this onto the UK statute book. Of significant concern however is the strain that the five-fold increase in customs declarations will put on HMRC's attempts to update their computer system for handling imports into the UK (the Customs Declaration Service – or 'CDS').

What this means

Businesses with activities in, and/or trading extensively with the United Kingdom will need to critically review supply chains and the robustness of existing records and systems to ensure that they are suitably equipped to cope with processing transactions that will no longer be regarded as intra-Community, and therefore subject in principal to the procedures regarding imports and exports that apply to transactions with third countries.

As regards the CDS system in the UK, Parliamentary confidence in the system has already dropped to 'business critical' levels. Failure to address fundamental concerns with the CDS will lead to goods being held up, and unworkable increases in lead in times for deliveries of goods coming from the EU into the UK, affecting businesses and consumers alike.

It will be interesting to monitor progress in these areas, not least following the UK Prime Minister's recent decision to call a 'snap' General Election on 8 June 2017

Generalised system of reverse charge

In a recent meeting, the European Council further discussed the possibility of allowing EU Member States to extend the use of the 'reverse charge' system as a means of preventing ongoing VAT fraud. Matters concerning the potential scope of the reverse charge and terms under which countries would apply for a 'derogation' from the Commission to apply it

What this means

The reverse charge mechanism involves shifting liability for VAT payments from the supplier to the customer. It thereby departs from the general principles of the EU's VAT system (laid down by the Principal VAT Directive – 'PVD') and the ability to apply this to domestic supplies (i.e. to avoid the risk of a 'missing trader' fraud whereby VAT is charged but then the supplier disappears before this can be brought to account) is promoted by Member States particularly affected by VAT fraud.

Under the proposed directive, Member States that wish to apply the reverse charge mechanism would be able do so in a generalised but temporary manner for domestic supplies above a specified threshold.

The directive would offer a short-term solution pending the preparation of a new VAT system, in which supplies would be taxed in the country of destination. This 'definitive' VAT system was announced by the Commission in an April 2016 VAT action plan but in principle has been on the agenda since the creation of the EU Single Market in 1993.

Andy Ilsley, RSM UK

INTRODUCTION OF VAT IN THE GULF COOPERATION COUNCIL COUNTRIES - UPDATE

The Gulf Cooperation Countries ('GCC') are gearing up for the introduction of a VAT system effective from 1 January 2017 and draft legislation is expected in the next couple of months. The UAE Ministry of Finance has said it will release its domestic VAT legislation by mid-2017. The standard rate of VAT will be 5%, as expected across the GCC, with narrow exemptions for local transport, financial services, life insurance products, sales of bare land and supplies of residential property; zero-rate reliefs will be available for education, healthcare and the first sale of residential property. The import of goods into UAE will be subject to reverse charges but, the import of goods into other Gulf Cooperation Council (GCC) countries shipped through UAE will not be eligible for reverse charge and import VAT will be due on these imports at the first point of entry into the GCC customs union. Registration will be mandatory for businesses with turnover in excess of $100,000, while businesses with turnover in excess of $50,000 may register voluntarily.

What this means

Businesses with activities in the GCC countries should undertake reviews now to ensure that their systems and processes are properly equipped to cope with the introduction of VAT on transactions there, in plenty of time so that any remedial changes can be implemented before the 'go live' date.

Martin Dane, RSM UK

RUSSIA

Rule change for e-services providers to Russian consumers

From 1 January 2017, new rules took effect for foreign companies providing electronic services to private individuals in Russia. Much like the equivalent 2015 rules in the EU, these are defined as services provided in an electronic form via the Internet (providing access to content (including computer games), providing web-hosting services, domain names and other similar services).

Under the new rules, E-services provided by foreign companies to Russian individuals are subject to Russian VAT where at least one of the following conditions is met:

- the customer's place of residence is Russia;
- the location of the bank where the customer has a bank account and uses it to pay for the services, or the location of the operator of electronic funds the customer uses to pay for the services is in the territory of Russia;

- the customer's network address used in purchasing services is registered in Russia;
- international country code of the phone number, used for the purchase or payment for services is Russia.

When providing Internet E-services to individuals, foreign i.e. (non-Russian) companies that provide such services are obliged to register and account for VAT at the rate of 15.25% and submit electronic VAT returns. Registration is required by no later than 30 days from commencement of such services being provided.

By way of further clarification, the new rules do not apply to the following transactions:

- sale of goods (work, services), if when making an order on the Internet, the goods are supplied (work is performed, services are rendered) without the use of Internet;
- sale (transfer of rights to use) of computer software (including computer games) and databases on physical sources;
- consulting services provided via email;
- provision of Internet access services.

What this means

The new provisions bring Russia into line with the EU rules that took effect from 1 January 2015 in ensuring that services are subject to VAT where they are consumed be they provided by domestic or international suppliers and that Russian providers of electronic services do not suffer from unfair competition as a result.

Providers of such services with Russian customers should therefore consider the new rules if they have not already to ensure compliance.

Evgeniya Voroshilina, RSM Russia

ITALY

VAT Group Implementation

The concept of VAT grouping allowed for in the PVD (whereby closely connected entities bound by financial, economic and organisational links can form a VAT group thereby becoming a single entity for VAT purposes, whereby VAT is not charged on transactions between group members) is being introduced into the Italian VAT legislation with effect from 1 January 2018.

Italian entities that are actively carrying out a business activity will be entitled to apply, if they wish, to join a VAT group, the effect of this being that all the group members will be treated as a single entity for VAT purposes. The only proviso is that they must be established in Italy – foreign establishments of Italian entities are not entitled to be part of a VAT group.

The VAT Group provisions are an alternative to the so-called "VAT Group settlement" scheme, whereby participants can offset VAT debt and credit positions within the Group and the holding company is the only one obliged/entitled to pay the remaining VAT due to, or ask for the refund of the net VAT credit from, the Italian tax authorities.

If the grouping eligibility conditions are met, the VAT group must remain in place for a three-year period as of the year in which it becomes effective and is automatically renewed on an annual basis unless revoked by the Group Representative.

What this means

Being regarded as a single VAT taxable person means the following:

(i) supplies of goods and services among the participants of the VAT Group are not subject to VAT

(ii) supplies of goods and services carried out by any member of the VAT Group to a third party (non VAT-group member) are regarded as carried out by the VAT Group as a whole;

(iii) supplies of goods and services carried out to a member of the VAT Group by a third party are regarded as carried out to the VAT Group as a whole.

The ability to not charge VAT on transactions between VAT group members will be particularly attractive to groups of companies that are unable to recover VAT in full because of the nature of their supplies (e.g. banks, insurance companies). One would assume that the grouping legislation will need to be refined and adapted, as has been the case in the UK for example, to prevent 'manipulation' of VAT groups to create an unfair VAT advantage.

Gianni Poggi and Claudio Romanelli – RSM Italy

UNITED KINGDOM

VAT exemption for cultural services

The CJEU has ruled the provisions in the PVD under which 'certain cultural services' should benefit from VAT exemption, cannot be relied on directly by UK tax payers (under EU principles of 'direct effect'); as the provision had not been transposed into UK VAT legislation. This meant that the BFI could not therefore place reliance on the EU legislation to recover output tax accounted for on admissions to the screening of films. The UK had specifically restricted exemption to 'live' cultural events.

The CJEU considered that, by referring to 'certain' (as opposed to 'all') cultural services, the legislature intended for Member States to be able to choose which supplies of cultural services should be exempt. Therefore, in so far as the provision allows the Member State discretion in determining the exempted cultural services, it is not capable of being relied on directly by BFI (or anyone else).

What this means

In implementing the VAT exemptions afforded under European VAT law, the UK deliberately elected to ignore, and exclude, VAT exemption to a number of cultural activities undertaken and performed in the UK. Claims submitted as a result of the tribunal decisions in BFI on the basis that the UK's implementation of the cultural exemption was too narrow are, as a result of this CJEU decision, likely to be rejected.

LATVIA AND POLAND

VAT cost sharing exemption

Two recently issued opinions from the Advocate General of the CJEU have provided further guidance on the extent to which entities can benefit from a VAT exemption set out in the PVD for the sharing of costs by independent groups of entities (known as the 'cost sharing exemption)

In a Latvian referral regarding DNB Banka the AG, first and foremost, states that as the relevant Article of the PVD is clearly defined, and unambiguous so can be directly appliedsufficiently precise and unconditional in its subject matter, it has direct effect.

The AG considers that an 'independent group of persons' does not have to be a legal person – but does need to be seen as a 'taxable person' in its own right, distinguished from its members, and the exemption from VAT is only applicable to transactions made, by the group to its members, not by its members to the group (or to other members).

The cost sharing exemption cannot be applied to cross-border supplies and does not apply to financial services but can only be applied on public-interest grounds, eg: social welfare; medical treatments; and education, specifically to relieve the burden and cost of VAT in these sectors and for them to enjoy the same benefits that they would have if the performed the services in house or formed a VAT group where intra-group transactions are not subject to VAT.

In a related opinion involving Aviva, this Polish VAT cost sharing case relates to shared service centres providing HR services, financial and accounting services, IT services, administrative services and customer service facilities in support intra-group (but not VAT grouped) cross border supplies relating to long-term savings plans, fund management and insurance services.

As in her Opinion in DNB Bank,the AG considers that the different treatment of groups falling outside and within the scope of the cost sharing exemption is based on whether they pursue activities in the public interest; the exemptions covered in the PVD being ntended to relieve consumers of the burden of VAT on public-interest grounds, eg: social welfare, medical treatments, and education.

As is the guiding principle, VAT exemptions must be strictly interpreted, and on that basis the AG considers that the cost sharing exemption is not therefore applicable to a group of insurance undertakings such as that at issue here.

Furthermore, the cost sharing exemption cannot be applied to cross-border supplies. The AG notes that the legislature has expressly restricted the scope of other provisions of the VAT Directive to the territory of a single Member State. Furthermore, as the wording of the PVDmakes it clear that the application of the exemption must not give rise to a distortion of competition, given the difficulty in assessing such across a number of states, this also indicated that the cost sharing exemption should be confined to a single Member State.

What this means:

The AG's Opinion in both DNB Banka and Aviva is a very thorough analysis of the cost sharing exemption and, although the CJEU isn't necessarily bound to, it could well follow the opinion when its ruling is published. Therefore, if the CJEU adopts the AG's Opinions in full it will find that:

- an independent group of persons must be a 'taxable' persons but necessarily a legal person;
- the independent group of persons can only make exempt supplies to members of the group;
- the cost sharing exemption only applies to specific 'public interest' bodies identified within the PVD and cannot be used by financial services or insurance providers or other services where such bodies can make alternative arrangements by having access to VAT grouping;
- transfer pricing mark-ups, or profit elements in general, means that the 'exact reimbursement' criteria fails;
- cost sharing exemption can only be applied in the local member state and cannot include multi-national or cross-border members;

- it is assumed as a rule that the services supplied by a group to its members on this basis do not give rise to a distortion of competition, but it would be for individual courts to define whether supplies by such a group did create any distortion of competition – other CJEU case-law confirms that such analysis must be on a case-by-case basis and that any listing of prohibited services or sector by the tax authorities would not be acceptable.

There are several other decisions on cost sharing due to be delivered by the CJEU, and a further decision in this respect has been released by the CJEU concerning infraction proceedings against Luxembourg concerning the 'exclusivity test, which has further clarified that attempts to restrict the wholly exempt test (in Luxembourg's case by stipulating that entities with up to 30% taxable activity are nonetheless entitled to receive exempt supplies from a cost sharing group) are ultra vires the PVD.

BULGARIA

Recovery of VAT on costs associated with free provision of services

The Advocate General has suggested in this Bulgarian case, the AG proposes that the CJEU should find that there is no entitlement to deduct input tax where the costs incurred relate to services supplied free of charge to a third party, even if the VAT bearing costs incurred were motivated by business reasons of the party incurring the costs.

By way of background, the company in question (Iderdrola) owned land in which it intended to operate a holiday village but, in order to connect the holiday lets to the existing municipal waste-water pump station, the pump station had to be extensively renovated. Without repair it was not possible to collect waste water from the planned buildings so the company and the local authority concluded a contract in which Iberdrola undertook to carry out the repair of the infrastructure at its own expense. The renovation was then carried out by a building contractor at the request of Iberdrola and Iberdrola sought recovery of input tax on these costs.

The AG points out that the existence of a direct and immediate link between a particular input transaction and a particular output transaction is, in principle, necessary before the taxable person is entitled to deduct input VAT, but a taxable person also has an entitlement to deduct where the costs are part of the general overheads as such creates a direct and immediate link to the economic activity as a whole. Where possible, however, costs should be directly attributed to particular income streams wherever possible.

However, CJEU case-law confirms that, in principle, a mere 'causal link' between the taxable output transactions and the input transaction cannot be sufficient of itself to grant deduction of input tax. In this instance, the crucial question was who (the taxpayer or the municipality) actually 'used' the construction and renovation services; this could only be the municipality as it was the person who maintains and operated the renovated infrastructure. Albeit Iberdrola had a motive for seeing the works done, i.e to enable it to carry out its holiday accommodation business, it provided the services to the municipality free of charge and therefore had no output transaction which gave an entitlement to deduct.

What this means

At face value, this would seem to contradict the CJEU decision in Sveda which, the AG acknowledges, has created some uncertainty in number of Member States over the extent of the deduction of input tax.

The AG does however seek to distinguish Sveda by pointing out that in Sveda, the CJEU had been able to identify that there was a direct and immediate link between the construction of the footpath (in that case) and Sveda's economic activity.

In the first instance, the AG observes that it was uncertain whether Sveda did actually make the footpath available to third parties free of charge given that a State subsidy was paid for it (the CJEU did not examine this question in detail).

Secondly, it was identified before the national court and CJEU that the footpath was actually going to be used by Sveda itself in conducting its own economic sales activity - this differed from Iberdrola as the renovated infrastructure did not relate to Iberdrola's economic activity, but was simply the condition for the construction of the holiday village, which is then used for leasing transactions.

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