

EU Amendment Directive

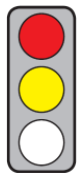
VALUE ADDED TAX – REVERSE CHARGE MECHANISM

Status: 07.12.09

MAIN ISSUES

Objective of the Directive: Through the voluntary and temporary application of the reverse charge mechanism Member States are to combat VAT fraud in a more efficient way.

Parties affected: Producers and traders of mobile phones, micro-chips, perfumes and precious metals; emitters and traders of greenhouse gas emission allowances; tax authorities.



Pros: The reverse charge mechanism is to be tested as a means to combat “carousel” fraud for a limited field of application and period only.

Cons: (1) The reverse charge mechanism bears the risk of merely shifting “carousel” fraud to new forms of tax fraud.

(2) Two VAT collection systems existing in parallel would burden companies and tax authorities due to the necessary restructuring measures and the related costs.

CONTENT

Title

Proposal COM(2009) 511 of 29. September 2009 for a Council **Directive** amending Directive 2006/112/EC as regards an optional and temporary **application of the reverse charge mechanism in relation to supplies of certain goods and services susceptible to fraud**

Brief Summary

► Aim

With the proposed amendment to the VAT Directive (2006/112/EC), the reverse charge mechanism is to be extended to include the trading of greenhouse gas emission allowances and goods susceptible to fraud limited up to 31. December 2014 in order to tackle VAT fraud more efficiently.

► Background

– VAT collection

- At each stage of a supply chain, from producer to distributor to end consumer, the added value generated by each entrepreneur is subject to taxation. Each company that provides goods or services and thus generates turnover is principally liable to pay taxes (Art. 193 VAT Directive).
- Every provider that is liable to pay VAT taxes to the treasury, charges its taxable purchaser with the tax amount due for the total invoice amount.
- In order to ensure that only the real added value is taxed at each stage of the supply chain, the input tax deduction procedure is applied: the taxable person concerned deducts the VAT amount – added in the course of the supply chain and charged by its previous supplier – as input VAT.
- Typical for the VAT system generally applied in the EU is the fractionated payment made by service providers at all stages of the production and distribution chain (“principle of fractionated payment”).

– “Missing Trader” and “Carousel” Fraud

- Basically, “missing trader” fraud is made possible when a VAT registered provider invoices supplies but then disappears without paying the amount due to the treasury. The entrepreneurial customer then exercises his right to input tax deduction and receives a refund for the invoiced VAT amount.
- In so doing, the fact that intra-Community supplies are exempt from tax (Art. 138 VAT Directive) is exploited: the VAT does not become due until the customer in the country of purchase acquires the goods or services. Though it is not necessary to carry out a cross-border transaction in order to commit “missing trader” fraud, it still facilitates that type of fraud significantly as it helps to conceal it and makes it difficult for tax authorities to monitor and investigate.
- “Carousel” fraud is an extended form of “missing trader” fraud in that the same goods circulate several times between Member States and tax amounts are misappropriated several times.
- Through “missing trader” fraud and “carousel” fraud the German treasury loses € 12–14 billion per year. The loss at EU level totals € 60–70 billion per year.

–“Reverse Charge” as an instrument to tackle fraud

- The reverse charge mechanism shifts tax liability from the service provider to the service recipient. Tax liability and the related right of input VAT deduction are thus combined in the person of the service recipient and are directly balanced to zero. The VAT is then charged at the end of the supply chain, when the good or service is finally passed to the end consumer who is not entitled to deduct any input VAT. The final service provider (mainly retailers) charges the end consumer with the VAT and then pays it to the treasury.
- Through the reverse charge system, payment flows which arise in connection with fractionated payments and which foster VAT fraud are avoided.
- Both the existing VAT taxation system as well as the reverse charge mechanism are based on the destination principle, whereby turnover is taxed on the basis of the tax rate applied in the consignment's country of destination.

► Field of application

- The Directive Proposal provides for a list of goods and services to which the reverse charge mechanism is to be applied (Art. 199a (1), Annex VI A revised):
 - Mobile phones, microchips, perfumes and precious metals, as these are considered to be particularly susceptible to fraud because they are small and valuable.
 - Greenhouse gas emission allowances, for which several cases of EU “carousel” fraud have been observed within the last few months.
- Each Member State may apply the reverse charge mechanism to greenhouse gas emission allowances and to two additional categories. The minimum introduction period is two years (Art. 199a (3) revised).
- The limited application field of the reverse charge mechanism is to ensure that the principle of fractionated payments with the service provider being liable to pay taxes remains maintained as a rule.

► Procedural specifications

- When introducing the reverse charge mechanism Member States must consider the following rules (Art. 199a (2) lit. a–d revised):
 - Both the service provider and the service recipient must be registered under an individual identification number in order to prove their entrepreneurship. This requirement is met, for example, with a VAT identification number (Art. 214 VAT Directive).
 - Member States must introduce “appropriate and effective” reporting obligations for each service provider and service recipient so as to enable the identification of completed transactions and the parties involved.
 - “Appropriate and effective” control measures to be introduced by Member States serve to monitor and mitigate current forms of fraud.
- In the run-up to the current Directive Proposal, a threshold was discussed according to which the “reverse charge” mechanism was to be applied only to domestic sales of more than € 5,000; however, the current Directive Proposal waived that idea [cp. COM Working Document SEC(2008) 249, p. 19].

► Member States’ reporting obligations

- Member States must inform the Commission as to whether, when or under which accompanying measures they intend to introduce the reverse charge mechanism (Art. 199a (3) revised).
- Member States must report to the Commission their experiences with the application of the reverse charge mechanism, in particular, with regards to the impact on fighting fraud and the costs incurred to the companies concerned and to the financial administration (Art. 199a (4) lit. a–f revised).

Changes Compared to the Status Quo

- The Member States’ option to impose tax liability on service recipients in certain areas is extended with the Directive Proposal. To date, that option has been possible for construction works, the acquisition of property or the supply of goods provided as security (cp. Art. 199 VAT Directive). Moreover, this option is also applicable to companies which perform their services in a Member State but are seated outside the EU (Art. 194 VAT Directive).
- In the case of other categories, to date Member States have been allowed to shift the tax liability to the service recipient only subject to a prior special permit by the Council (Art. 395 (1) VAT Directive). This requirement is now removed for the categories in the scope of the Directive Proposal.

Statement on Subsidiarity

According to the Commission, the Directive Proposal is in line with the principle of subsidiarity, as it is a temporary measure to combat VAT fraud which deviates from the VAT Directive as a regulation at EU level and therefore requires its amendment.

Policy Context

In July 2006, the Commission rejected a motion filed by Austria and Germany for the general introduction of a reverse charge mechanism for any sale above a threshold of € 5.000 or 10.000, reasoning that it was too far-reaching and would only be possible by means of a formal amendment of the Directive itself.

In February 2008, the Commission's stance was still critical regarding the right of Member States to shift tax liability [COM(2008) 109; p. 10]: It would lead to "a second system at EU level and thus have negative consequences on operation of the internal market". The "optional character of a generalised reverse charge system has been identified as a cost factor for businesses and as one of the main factors creating risks of new types of fraud within the EU". In May 2008, the Council of Finance Ministers were also not able to reach an agreement on the Austrian pilot project for a generalised introduction of the reverse charge mechanism. Recent reports on "carousel" fraud with emission certificates have accelerated the submission process of the Directive Proposal. On 2. December 2009, the Council of Finance Ministers generally agreed on the introduction of the reverse charge mechanism on the basis of the Directive Proposal. It is to become applicable in Member States until 30. June 2015.

Legislative Procedure

29.09.09 Adoption by Commission
02.12.09 Council General Approach
24.02.10 Statement by the European Parliament

Options for Influencing the Political Process

Leading Directorate General:	DG Taxation and Customs Union
Committees of the European Parliament:	Economic and Monetary Affairs (in charge), rapporteur: David Casa (EPP Group, MT)
Committees of the German Bundestag:	Finance
Decision mode in the Council:	Unanimity

Formalities

Legislative competence:	Art. 113 TFEU Finance, indirect taxes (ex-Art. 93 TEC)
Form of legislative competence:	Shared competence
Legislative procedure:	Special legislative procedure (EP hearing)

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

The reverse charge mechanism is by all means a suitable instrument for combating VAT fraud in the hitherto known cases. However, **its application is likely to create new forms of fraud**. The Commission expects this and even goes so far as to actually name the faking of invoices, the facilitated shifting to the more attractive prices of the black market and the use of counterfeit VAT identification numbers in order to feign entrepreneurship [SEC(2008) 249, p. 20–22].

Since the introduction of the new system is voluntary, it is probable that the existing forms of fraud will migrate to those Member States which will maintain the existing VAT system. This could generate a certain pressure to implement an EU-wide reverse charge system.

Impact on Efficiency and Individual Freedom of Choice

Limiting **the application of the reverse charge mechanism** to only a few categories and tradable greenhouse gas emission allowances is justifiable within the framework of a limited testing phase, so as to be able to gather experience in applying the new system. However, **for the companies concerned this would result in an increased administrative burden**, as they would have to use two parallel systems of VAT tax collection if at the same time they were also distributing goods or services not subject to the rules of the reverse charge mechanism. In particular, retailers would face the problem that they would have to verify whether their customers are entitled to deduct input tax (then they could not charge VAT on the goods and services concerned) or not (then they must charge VAT).

The reverse charge mechanism would only mean improved security if supplemented by comprehensive documentation and reporting obligations, as stipulated by the Directive Proposal. In other words, the price for avoiding a tax deficit would be an increased administrative burden.

Although greenhouse gas emission allowances are subject to VAT, no substantial tax revenues are generated since most of the buyers of certificates are entitled to deduct input tax. To fight fraud effectively it would be much easier to exempt the allowances from VAT.

Impact on Growth and Employment

Unproblematic.

Impact on Europe as a Business Location

Unproblematic.

Legal Assessment

Legislative Competence

Pursuant to Art. 113 TFEU (ex93 TEC), indirect taxes such as VAT may be harmonised if required to establish and operate the internal market. Tax fraud, if fostered by the cross-border movement of goods and services, not only lowers tax receipts but also leads to distortion of competition and thus threatens the proper functioning of the internal market.

Subsidiarity

The temporary introduction of a reverse charge system aims at avoiding VAT fraud in the EU. In particular, intra-Community carousel fraud is fostered by the fact that cross-border sales are tax-free. The Directive Proposal enables all Member States to counter VAT fraud by applying the reverse charge mechanism on a voluntary basis. The optional and temporary character of the system is in line with the principle of subsidiarity.

Proportionality

The reverse charge mechanism represents a viable possibility for combating “missing trader” and “carousel” fraud. Until now, conventional methods such as control and reporting requirements have failed to tackle the problem effectively. It is up to the Member States’ to decide whether or not they will introduce reverse charge into certain fields of application in order to evaluate its efficiency as a fraud combating tool. The costs necessary to finance the restructuring and re-organisation for reverse charge could, on the one hand, have burdening effects on companies – specifically, if they must apply both VAT taxation systems. On the other hand, reverse charge has the effect of protecting liquidity, as VAT would no longer be due in fractionated payments at different stages in the supply chain but at the end. The temporarily extended introduction of the reverse charge system within a limited field of application with the aim of combatting fraud is therefore appropriate.

Compatibility with EU Law

Unproblematic.

Compatibility with German Law

In certain cases, according to § 13b sales tax law (*Umsatzsteuergesetz – “UStG”*) Germany has already made use of the options available until now to make the entrepreneurial recipient of goods and services liable to pay tax (for instance in construction work or property acquisition). In the case of an introduction of the reverse charge mechanism according to the Directive Proposal, the UStG would have to be adjusted to a larger extent. This would affect, for example, the proposed reporting obligations of service providers and recipients and state control measures.

Alternative Action

The root causes of cross-border “carousel” fraud could be eliminated if VAT taxation were shifted from the destination principle to the country of origin principle. A consignment’s added value would thus already become taxable in the export country. Concealing tactics in the “carousel” would be removed through the omission of the tax-free intra-Community supply.

Possible Future EU Actions

Positive experience from Member States could lead to a further-reaching introduction of the reverse charge mechanism in that the time limitation is waived and the scope of goods and services is further extended.

Conclusion

Though the reverse charge mechanism is suitable in order to combat certain forms of VAT fraud, it is, at the same time, susceptible to new forms of fraud. Moreover, it is likely that the existing forms of fraud will migrate to those Member States which do not introduce the reverse charge system. For the companies affected, the new system leads to an increased administrative burden. This is why an extended introduction of the reverse charge mechanism should be waived.