

THE TAX ADVISER

New VAT Rules Regarding International Services

TAX CLINIC

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Published August 01, 2010

Foreign Income & Taxpayers

As U.S. closely held businesses expand their operations overseas, they are likely to encounter value-added tax (VAT). Many foreign countries already have VAT systems in place. This item focuses on recent European Union (EU) VAT legislative changes (EU Council Directive 2008/8/EC) and how they will affect the provision of international services. U.S. legislators have discussed implementing a VAT system, so VAT may become an issue that U.S. businesses will have to grapple with at some stage.

Key Concepts

There are several key concepts that are paramount to the accountability of VAT.

Goods versus services: In general, a good is a physical product, the ownership of which is transferred from a supplier to a customer, with an invoice raised and payment received. The rule of thumb is that if it is not a supply of goods, it is a supply of services. (In general there is no VAT payable on free services.)

Place of supply of services: Unlike the supply of goods, the determination of the place of supply of services is crucial because this determines in which country the VAT is due. It is important to understand that not only is the place of supply in the customer's country but the supply itself is deemed to be by the customer, not the actual supplier.

For example, if the service provider is U.K. based but the place of supply is in another EU country (e.g., France), either VAT will be payable in France at the French VAT rate via the reverse charge mechanism (see below) or the U.K. company will have to register for VAT in France. However, if the service provider is based in the United Kingdom but the place of supply is in the United States, no VAT is chargeable because the supply is outside the scope of VAT (because the United States does not have a VAT system).

VAT and International Services: Old Rules

Before January 1, 2010, if a U.K. company supplied services in the United Kingdom to either a business-to-business (B2B) or a business-to-customer (B2C) customer, appropriate U.K. VAT was required to be charged on the work. The general rule was that the customer's location had no impact, but there were some very important exceptions to this general rule (e.g., the place of supply for services provided for land is always where the land is located).

VAT and International Services: New Rules

Since December 31, 2009, the general rule has gradually been replaced by the exceptional rule. A company now has to determine whether the supply of services is a B2B or B2C transaction. If it is a B2B transaction, the place of supply of services is where the customer is located. For example, when a U.K. company (supplier) provides management services for a U.S. subsidiary (customer), under the new rules the place of supply is the United States, which is where the customer is located.

In a B2C transaction, the place of supply is where the supplier is located—e.g., if a VAT-registered U.K. accountant prepares a U.K. tax return for a private client who resides in the United States, the accountant is required to charge U.K. VAT.

One of the main premises behind the change in the rules is that now all B2B transactions are on a level playing field. Under the old rules, a Danish business could contract with a U.K. company for U.K. services and be charged VAT at 17.5%, whereas if the customer contracted with a Danish company for the same services it would be charged VAT at 25%. Assuming that the Danish company is a VAT-exempt business—i.e., unable to claim the VAT back—by contracting with the U.K. business they are saving 7.5% in unrecoverable VAT.

Assuming the same facts, under the new rules the place of supply is Denmark, so the services will be subject to 25% VAT, which is the same rate that the Danish company would have incurred if it had hired a Danish firm to provide the services; the competitive advantage of working with the U.K. company has been neutralized.

Accounting for VAT Under the New Rules

Consider the following situation: A U.S. parent company (supplier) provides £150,000 of management services to the U.K. subsidiary company (customer) during a 12-month period. What are the VAT implications? As discussed above, the place of supply after December 31, 2009, is where the customer is: the United Kingdom. Thus, the management services are subject to VAT at the U.K. 17.5% rate: £26,250. The question is how to account for this VAT. There are two possible solutions:

- If the U.K. company is VAT registered, it can account for the VAT by applying the reverse charge mechanism on its own VAT return; or

- The U.S. company can register in the United Kingdom for U.K. VAT and account for the output VAT to the U.K. tax authorities on its own account.

What Is the Reverse Charge and How Does It Work?

Using the above fact pattern, the principle of the reverse charge is that the U.K. subsidiary, rather than the U.S. parent company, accounts for any VAT charged by the U.S. company on the supply of management services to the U.K. subsidiary. From a compliance perspective, it is important to implement the reverse charge where possible because it would avoid the U.S. parent company's having to register for VAT in the United Kingdom.

Furthermore, it must be remembered that the U.K. subsidiary is deemed to have made the sale, not the U.S. parent. The consequences can be important. If the value of the management services provided to the U.K. company plus the U.K. subsidiary's own sales in a 12-month period total less than £70,000 (the current U.K. VAT registration limit), the U.K. company is not required to register for U.K. VAT. But if the value of the management services plus the U.K. subsidiary's own sales exceed the U.K. registration threshold, the U.K. company must register for VAT. This would not apply if the U.S. parent company decided to register in the United Kingdom; in that case the subsidiary would not be required to charge VAT on the services rendered by the U.S. parent. The U.S. parent would instead charge and remit the VAT directly. If the U.K. subsidiary was otherwise below the threshold, it would have no VAT registration requirement. Note that the VAT registration thresholds vary from country to country.

It is sometimes complicated to determine whether the supply of services is a B2B or B2C transaction. For example, a VAT-registered U.K. company may supply management services to various companies in both the United Kingdom and the EU. A practical solution is to request proof of an EU VAT registration number. If the customer can provide a VAT number, check that it is a genuine VAT number by either contacting the U.K. VAT National Helpline (phone +44 845 010 9000) or using the European Commission's Europa website (http://ec.europa.eu/taxation_customs/vies/vieshome.do). If the VAT number is genuine, the VAT-registered U.K. company can probably assume that it is providing services to a business and that the place of the supply is the customer's country of fixed establishment. If the customer is unable to provide a valid VAT registration number, the company should assume that it is a B2C transaction and charge the appropriate amount of U.K. VAT on the services provided.

EC Sales List

For many years, EU companies have had to report the sale of goods to VAT-registered businesses in other EU countries. Effective from January 1, 2010, an EU business supplier providing services to another EU business customer, where the customer must account for the reverse charge, must report all such transactions on an EC sales list.

The purpose of the new reporting requirement is to enable tax authorities to confirm that the reverse charge is being accounted for correctly by the various EU businesses. This is especially relevant where the customer business in question is partly VAT exempt and cannot fully reclaim all the input VAT.

Conclusion

Effective starting January 1, 2010, a U.S. company providing services to an EU business may be subject to the new VAT rules and will have to register for the VAT in that business's jurisdiction, or the business will have to account for the VAT using the reverse charge mechanism. Most closely held businesses that charge management fees among the various group companies should be particularly aware of these new rules and determine whether they apply, depending on the individual facts and circumstances.

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