

BROADENING THE REVERSE CHARGE MECHANISM
IN RESPECT OF DOMESTIC SUPPLIES

I. Purpose of the document

The Room Document intends to outline possibilities, pros and cons of using the reverse-charge mechanism on domestic supplies within the current VAT system. The document reflects the development of the EU VAT system as well as current conditions of VAT collection and it gives some ideas for the possible future use of the reverse charge in this context.

II. History and background

The principle of the VAT system is characterised by fractionised payment when the VAT is charged at each stage of the production and distribution chain. The VAT on purchases is collected from the supplier and the buyer has the right to deduct the VAT from purchased goods/services on the other side. The *reverse charge* mechanism transfers the liability to declare and pay the tax from the supplier to the customer; the customer is paying and deducting the VAT via the same VAT return. The reverse charge mechanism has been introduced with the aim to tackle the risk of “missing trader fraud” where the supplier does not pay the VAT from sales but the customer has the right to deduct VAT paid on the other side. The missing trader fraud has developed dramatically with the development of single market. The more goods and services were circulating freely the more alerted tax administrations in different Member States needed to be, and the more frequent was the use of reverse charge mechanism.

The reverse charge mechanism forms a part of the VAT system (nowadays Articles 194 – 199 of the Council Directive 2006/112/EC (hereafter “VAT Directive”). The scope of transactions listed was rather limited at the beginning. The possibility to use the reverse charge was broadened in 2013, by introducing Articles 199a and 199b to the VAT Directive, as a response to ongoing calls from Member States for adding new goods and services to the list of goods and services to which the reverse charge could be applied in order to effectively fight against fraud that occurs in other sectors. Two parallel approaches to the VAT collection (the tax collected from the supplier and the reverse charge where the tax is collected from the buyer) have existed for many years abreast and no significant problems with this coexistence have been noticed.

The system of VAT in the EU is common but at the same time the administration of the VAT system is very specific in each Member State. Many differences in collection of harmonised VAT exist because this harmonised tax is being collected by 28 different tax administrations. No or minimal harmonisation exists in relation to the data required from taxable persons by tax administrations or to the form of its submission.

All 28 tax administrations evolved dramatically over the time common VAT system has existed. VAT returns and other declarations are submitted mainly electronically and control systems became more automated and reliable. The level of data processing and its efficiency is significantly higher than several years ago. The progress in this area enables better control of the tax compliance and more efficient environment not only for administrations but for businesses as well.

III. Domestic reverse charge mechanism

The current legal basis for the application of the reverse charge is to be found in Articles 194 – 199 and 199a of the VAT Directive. The reverse charge is applied by a majority of Member States; the actual range of use differs. The major aim of the reverse charge is the elimination of the double loss caused by missing trader fraud in cases when the supplier did not pay the VAT and the customer claimed the VAT deduction from the purchased goods or service at the same time. Once the reverse charge was introduced by a Member State, it has not been abolished because the experience shows that the reverse charge as an anti-fraud measure simply works.

Article 199 of the VAT Directive has its origin in individual derogations previously granted to individual Member States based on derogation. The subsequent integration in the VAT Directive confirmed that the measures were successful in fight against the carousel fraud. Member States felt they should be made available to all Member states so that they could benefit from them.¹

Article 199a of the VAT Directive gives the possibility to apply temporary reverse charge to certain fraud-sensitive sectors. The measure has to be introduced for a minimum period of two years until 31 December 2018. As this deadline is approaching it is necessary to start working on what is going to happen beyond this point.

Article 199b of the VAT Directive (so called “quick reaction mechanism”) gives Member States the possibility to apply for the derogation from the main rule in specific cases in order to reduce the risk of the tax fraud. Application for derogation has to be submitted according to Article 395 at the same time. Although the QRM tool has been in place for almost two years, we have not seen any case where it would be made available in practice.

The available possibilities to apply reverse charge mechanism given by the VAT Directive are broadly used by Member States as an anti-fraud measure. The number of requests based on Article 395 submitted to the European Commission increases gradually. It may imply that Member States have considered this tool rather efficient in tackling VAT fraud. This option is frequently used by Member States on varying scope of transactions within the limits given by the VAT Directive. No negative impact of the reverse charge mechanism has been reported considering the volume of intra-community trade in relation with domestic transactions.

1 European Commission – Assessment of the application and impact of the optional „Reverse Charge Mechanism“ within the EU VAT system;
http://ec.europa.eu/taxation_customs/common/publications/studies/index_en.htm

Reverse charge in limited number of situations is being used in combination with so-called conventional measures the number of which gradually grows as well. Despite that the VAT collection in the EU shows constant and considerable gap. In 2012 EU Member States lost almost 165 billion euro, and 168 billion euro in 2013. The actual figures change according to the VAT gap computation methodology modifications, nevertheless the tendency has been stable. It shows the VAT gap over 20% of the overall VAT liability in at least 10 Member States in last several years. It is rather worrying.

The Czech Republic as many other EU Member States have introduced a number of new conventional measures recently. Some of them were presented at the High Level Working Party in September 2015. Unfortunately, the effect has not been as remarkable as expected.

Resistance of the amount of the VAT fraud and the susceptibility to modifications, flexibility as regards the commodities in question demonstrates that it is very difficult to eliminate carousel fraud through the isolated introduction of conventional methods. Efforts and energy invested by Member States over last years in determination of the risk commodities to which it is possible to introduce the reverse charge mechanism in line with the VAT directive confirms that, too. Flexibility of the commodities used for the carousel fraud must be even higher in reality. The measures that are currently available, including the quick reaction mechanism, are insufficient for efficiently fighting against the missing trader fraud.

The Czech government set the fight against the VAT fraud as the key priority and considers the reverse charge mechanism being a potentially efficient tool for the fight against the carousel fraud. In this context, the Czech Republic together with Austria, Bulgaria and Slovakia applied for the authorisation of introducing a special measure derogating from Article 193 of the VAT Directive with regard to the persons liable for payment of VAT, in order to simplify the procedures for collecting VAT or to prevent certain forms of tax evasion or avoidance, in June 2015. The Commission did not share the view that the reverse charge is one the most effective way to combat carousel fraud or to reduce the VAT fraud and objected the above-mentioned request on 28 October 2015.² This joint request was rejected by the Commission similarly as those submitted by Austria and Germany almost ten years ago with very similar reasoning.

Taking into account the increasing number of requests, a question arises whether the possibility to discuss this kind of measure at the Council level should not be given to Member States. The output of the discussion can outline the possible future steps when applying reverse charge.

IV. Intra-Community transactions comparison

Taxation of intra – community supplies of services results in a situation that resembles the reverse charge mechanism to some extent. The tax liability is, in principle, charged reversely as well. Those transactions are controlled via the specialized VAT Information Exchange System (VIES).

2 COM (2015) 538 final

Two principles of VAT collection exist in the field of domestic supplies – the collection by fractional payment and the reverse charge. Using modern IT technologies the control of domestic transactions under the reverse charge mechanism seems to be easier than the control of the Intra-Community trade.

V. The impact of the reverse charge

Reverse charge is often presented as the end of VAT system and return to turn over tax. Looking at structural elements of the VAT with and without reverse charge mechanism more closely shows the opposite. The tax base, tax rate, taxable transactions, place of taxable supply etc. can remain exactly the same whether or not the reverse charge mechanism is applied. The only element that changes is the point of collection of cash VAT by the tax administration. The fiscal neutrality of the tax is kept. The overall amount of VAT collected does not change, the VAT revenues remain unchanged (or they should grow because of the reduction in VAT fraud) when applying the reverse charge. The reverse charge can keep the neutral character of VAT. The history shows no impact on single market and it does not affect the competitiveness of EU businesses. Reverse charge mechanism has even a positive impact on the cash flow of businesses as they do not have to wait for the excess tax deduction paid off by tax administration. VAT fraud on the other hand significantly harms competition and proper functioning of the internal market. So far introduction of the reverse charge mechanism on the fraud sensitive commodities has brought positive impact on the situation on the market, i. e. elimination of tax fraud and abusive competition.

VI. New scope and new risks

The wider use of the reverse charge mechanism could tackle problems like the missing trader fraud, it is easy to apply and efficient but some new risks could arise as well. Non-payment of the tax at the end of the business chain is the key risk. Potential transfer of the VAT fraud to the end of business chain can be eliminated by introduction of new tools relying on modern technologies, namely specific reporting obligation enabling the tax administrations to cross check the ledgers on line. Tools being used in collection of VAT have developed dramatically over last 10 years. Modern technologies give effective tools to control the tax compliance at the end of the transaction chain to fiscal administrations. In case the end of the chain is controlled, the risk of the non-payment of the VAT due would be significantly reduced. The tax will be collected only once and the procedure of VAT collection would be simplified. The implementation of the reverse charge mechanism would also reduce the VAT gap of Member States. The last study on VAT gap in the EU has indicated that common VAT enforcement and compliance measures are not sufficient and a new approach to the tax fraud on VAT has to be found. With wider application of reverse charge mechanism the tax could be collected only once, therefore tax audit will be more efficient and it will put fewer burdens on businesses. Tax administration would be able to focus on the end of the business chain. It would no longer be true that wider application of RCM would push the fraud to neighbouring countries since the electronic filing of ledgers would have this effect, too. In the environment where tax administration is fully capable of controlling the end of business chain through modern technologies the application of reverse charge makes more sense than fifty years ago when the common VAT system was introduced.

The risk of transfer of the fraud in other Member State does not seem very relevant any longer. Such risk is comparable to the risks when one Member State introduces a massive and successful introduction of any conventional measure against the VAT fraud. In other words it would be wrong to link specifically reverse charge mechanism and its scope to this particular risk.

VII. Implementation of the reverse charge mechanism

From the cash-flow point of view, we can consider two methods of the implementation. If the aim is to minimize negative cash-flow effects affecting both businesses and tax administrations, the system should be implemented step-by-step so that the market could adapt to the new situation smoothly. Another approach is the “big bang” where the system of the collection would be changed at once. The positive effect of this is that there is not a transitional period with two parallel systems, which could lead to additional administrative costs. In case of this method an impact on the cash flow of the state has to be deeply evaluated.

The reverse charge is implemented only to selected business sectors with the aim to tackle the carousel fraud in those specific areas today. Application of the reverse charge mechanism on the particular transactions could cause difficulties in the identification of the transaction whether reverse charge mechanism should be applied or not. It is necessary to clearly define all commodities and services, where reverse charge mechanism should be applied. Problem with identification of the transaction could be eliminated with the application of the general reverse charge mechanism.

The application of reverse charge on specific items and business areas has not proved to be viable solution. Carousel fraud can be carried out on a wide variety of products and services and is very flexible to move from one to another. The experience of many years shows that the only reliable common denominator is the high value of the supply that is capable of bringing substantial loot to the fraudsters. It is possible to eliminate this type of fraud only by determining the relevant sector by the size of the transaction.

The general reverse charge without threshold is a possible approach to benefit from an easier administration of the tax and simple VAT system (two parallel ways of VAT collection would not exist in this system), on the other side some additional administrative burden can arise to small enterprises. Therefore it may be wise to limit the measure to situations above certain threshold. The threshold would function as the prevention of the tax fraud. At the same time it will not create any additional burden for tax administration and businesses. This will ensure that the measure is well targeted and in line with the principle of proportionality. The essential VAT concept will remain preserved.

Potential procedures of broadening the reverse charge mechanism in respect of domestic transactions above certain threshold are as follows:

1. Using the Article 395 of VAT Directive. This does not seem to be a possible solution any longer since the Commission assesses this scope to be outside the legal framework of this provision.
2. The broader application of reverse charge could work as an alternative for the definitive VAT regime. This alternative would require amending the VAT Directive. Member States and European Commission have so far discussed different forms of the definitive VAT system but

the consensus about the final VAT system has not been reached yet. The reverse charge mechanism is one of possible scenarios to be discussed and there is still some space to get experience from its functioning in a broader scope. The broad discussion and deep examination of the reverse charge mechanism impacts on the future VAT system are needed in order to find the best solution.

3. The partial and temporary broader application of the reverse charge could give the opportunity to test the actual impact in the short term. It is difficult to evaluate the possible impact of the reverse charge on a new VAT system because of lack of concrete information. If a current VAT concept is kept, the experience from the eventual pilot project could help to consider whether the reverse charge could be a way in the right direction or not and it could help to set the new system as well. The pilot project applied by one or two member state could give such information.

There are some conditions that have to be fulfilled when introducing a pilot project. Firstly the pilot project has to be applied by the member state(s) taking part in the pilot project and domestic transactions have to be involved only. The member states engaged have to be technically prepared for the running of such system, especially by implementing the control mechanism, by introducing necessary declarations, etc. to be able to control the VAT at the end of the distribution chain and to minimize risks of VAT losses. The legislative base at the national level has to be ready as well. The Czech Republic is ready to participate at the pilot, it has required IT tools and declarations including the appropriate legislation.

Not only Member States have to prepare conditions for the realization of such a project. It is the European Commission as well who bears the burden of its preparation. Already in 2008, the Commission recognised that there was an absence of any empirical evidence concerning the generalised reverse charge and at that time declared its willingness to proceed with the preparatory work to allow a volunteering country to start a pilot project. Under current conditions, when different options of the definitive VAT regime have been discussing, it is more than obvious that the Commission should consider the pilot project again.

VIII. Conclusions

The reverse charge mechanism is not a new measure. The reverse charge mechanism does not necessarily dramatically change the current VAT system. Both systems have coexisted together for years without any serious problems noticed. There is no negative experience with the sectors where reverse charge has been introduced; the objective of the measure – the tackling of VAT carousel fraud in these sectors – has been reached. No serious distortion of the market as well as no negative effects on traders caused by the introduction of the reverse charge mechanism has been recorded yet. The reverse charge mechanism is just the method for VAT collection; it is not the change in the VAT system. The structural elements of the system remain unchanged. Contribution of the reverse charge mechanism is particularly in the field of the fight against VAT fraud (especially carousel fraud).

It is to be emphasized that the role of the reverse charge has increased and technical conditions (esp. the development of IT systems) has considerably changed during last ten years. The announced increase of the administrative burden is notably reduced by the use of electronic means.

The preparation of a new definitive system of European VAT is in progress, the pilot project of the general domestic reverse charge could be a useful tool to examine pros and contras of this measure before the final decision will be done.

It is obvious that broader application of the reverse charge mechanism deserves to be elaborated further in a structured debate. Whether it is a viable solution for future and answer to the key part of the VAT fraud in the EU must be addressed not only by experts but at the top political level as well. VAT fraud in the EU has not been successfully eliminated since the common system of VAT was introduced. The common VAT system is in urgent need of a reform. Broadening the reverse charge mechanism and giving more flexibility to Member States in VAT collection is a relevant alternative that should shortly after the discussion among experts seek orientation from Ministers of Finance as well.

Questions for discussion:

- *Against the background that the problem of VAT carousel fraud in the EU must be solved, do delegations consider the reverse charge mechanism to be an option for taxation of some domestic supplies in future and, as such, it deserves further analysis?*
- *Do delegations agree that it would be useful to examine effects of this measure before the definitive system is established? If so, by what means the relevant information should be obtained?*
- *Could a pilot scheme similar to the one prepared in 2008 bring relevant experience and information? If so, what parameters Member States see as key? If not, what other alternatives could be used?*
- *Which potential problems delegations envisage in the pilot project? How could they be eliminated?*