The EU’s new Rube Goldberg machine: EU VAT 2015 - and how to deal with it
1 Introduction

The beginning of 2015 brought some considerable headaches to Europe's online businesses. On January 1, 2015 the new EU VAT regulation became effective, which requires companies that sell digital products to consumers to completely rework the way they calculate and handle VAT in their online payment process.

Unfortunately, some of the new rules seem to be ill thought-through at best, and the documentation provided is often unclear and sometimes even contradictory. Worse, when speaking to business people about the matter in the past weeks I realized many are still unaware about the change and what it may mean to them. In this post I’d like to share our experience with this challenge and how we implemented the new regulation.
The EU’s new Rube Goldberg machine: EU VAT 2015

2 The new EU VAT 2015 rules

First of all, what’s so dramatic about the new EU VAT laws? Well, to companies supplying digital goods and services to consumers it means a total change in the way VAT is calculated; this is likely to affect their entire online checkout and billing process.

2.1 What changes?

The VAT rate is determined by what is called the place of supply. Under the previous regulation the place of supply was based on the address of the vendor. A German buyer purchasing a song from a UK web site would be charged UK VAT.

For certain digitally delivered products, under the new regulation the place of supply becomes the buyer’s place of residence. In the above example, the same German buyer would now be charged German VAT. It does not sound dramatic but the repercussions are far-reaching.

2.2 What does it mean?

As a consequence, the vendor now needs to

1. Determine whether the product to be sold falls under this new regulation
2. If the product falls under this new regulation, determine if the buyer is a business or a consumer
3. If the buyer is a consumer, determine the buyer’s place of residence and collect proof
4. Apply the correct local VAT rate
5. Charge and collect the correct VAT rate
3 Scope: Who is affected, who is not?

You are affected by this new regulation if ALL of the following criteria apply to you:

- You are selling online
- You are selling digital services (incl. digital, broadcasting, telecommunications services)
- You are selling to EU consumers
- Your ordering and delivery process is fully automated (e.g. customers order, pay and download music files via a web site)

You are not affected if ANY of the following criteria apply to you:

- You are not selling online
- You sell to business customers only
- You do not sell to EU consumers
- You only sell physical goods or non-digital services
- You sell your digital goods and services through a 3rd party marketplace (the marketplace provider needs to be compliant with the new EU VAT rules)
- Your ordering and delivering process is not fully automated (e.g. customers order electronic reports online and you manually send them an email with the report as an attachment)

3.1 What are digital services?

- Radio and television broadcasting services (incl. live streaming, audio, video content)
- Telecommunication services (incl. mobile, fixed telephony services, VoIP, internet access)
- Electronically supplied services (incl. images, texts, e-books, music, films, games, web hosting, software, advertising space on a web site)
4 Key challenges

Now you know the fundamental changes and who might be affected. If you’re not affected you are lucky indeed because if you are the fun only begins now.

4.1 Identifying consumers and businesses

You need to identify whether your customer is a business or a consumer. This is relatively easy. The only way a customer can really prove they are a business is if they provide a valid VAT number. For the UK HMRC provides very clear guidance on that point. In that case the reverse charging principle kicks in, which means that the vendor does not need to charge VAT.

4.2 Determining the place of residence

This part is a tricky one. Merchants are required to obtain two non-conflicting pieces of evidence to prove the customer’s place of residence in order to determine the correct VAT rate. This could be

- The customer’s billing address
- The IP address of the customer (i.e. the country mapping of the IP address)
- The customer’s bank details
- The country code of the SIM card used by the customer
- The location of the fixed line access used by the customer
- Other information such as country-specific product coding

What this also means is that when you cannot obtain the two non-conflicting pieces of evidence you cannot determine the correct VAT rate, which ultimately means you cannot charge the customer and you cannot complete the payment process. This obviously is far from appealing since the probability of losing this sale is very high.

Due to the nature of our business we have the billing address for all our customers. However, none of the other potential pieces of evidence are necessarily conclusive. We do not ask for the credit card upfront, and in fact we do not hold any credit card data ourselves in order to remain fully PCI (Payment Card Industry) compliant. Our customers are travelling, so IP address and fixed line access are not necessarily matching the billing address. Which leaves us with a mobile number (MSISDN) verification via text message, which only works if the customer has a mobile number from the same country as the billing address. In our case, this can also not be guaranteed.

At this point I should mention we are using Taxamo.com (and Braintree as a payment provider) to handle the abovementioned verification process. They check the IP address, perform the text message verification etc., store all the evidence and create a list of EU VAT transactions that we can pass on to the HMRC.

4.3 EU VAT exceptions

The entire evidence collection process described above is based on the assumption that the consumer’s country of residence determines the correct VAT rate. Well, not. The EU decision makers and national tax authorities seem to have also overlooked the fact that there are areas in EU member states where different VAT rates apply or which are entirely exempt from VAT. For instance, you might be aware that the Canary Islands, the French overseas departments or the Channel Islands in the UK are exempt from VAT. However, at least I was surprised to see how many exceptions there are even in countries like Austria, Germany, Denmark, Finland, Italy and more.
There is very little information out there about how to handle these exceptions in the context of the new EU VAT regulation. Only Portugal released some information that the Azores and Madeira should be treated as the mainland in the interim. 

Admittedly, the number of customers from these areas is likely to be small. However, if you do get a customer from such an area how does your automated buying process handle this? If you do not want to lose your customer by overcharging them you need to find a way to charge VAT correctly.

Again, the problem is that beyond the billing address none of the abovementioned pieces of evidence allows you to establish whether the customer’s place of residence is in fact located in one of these EC VAT exception areas. Unfortunately, even Taxamo at the time of writing was not yet ready to handle this topic, so we needed to adjust the process ourselves and basically allow self-certification in conjunction with some plausibility checks.

4.4 Handling the collected VAT

As a vendor you collect the VAT and pass it on to the respective tax authority in the respective member state. In principle, you need to register for VAT in every EU country from which you collect VAT from the first Euro onwards.

Fortunately, in this case there is a bit of a shortcut. If you are a small or medium-sized company, you can register for the VAT Mini One Stop Shop (MOSS), which allows you to pass all VAT to your local tax authorities - in our case the HMRC. Your local tax authority will then distribute the respective VAT to the tax authorities in the other member states.

I can just imagine how all national tax authorities are currently busy creating new departments to handle the intra-EU VAT revenue exchange game.

By the way, depending on the amount of VAT to be paid to a specific country, larger companies may need to register for VAT with the tax authority in each EU members state. Every EU country has a different threshold, so if you are generating millions of EUR in VAT from a particular country you better find out what the threshold is.

4.5 Keeping records

As a vendor you need to create and keep records of all transaction involving EU VAT, so that the local tax authority can actually determine how much of the VAT needs to be passed on to which other country. These records need to be kept for 10 years.

For every transaction you need to store the following information:

- Where the customer is from
- Whether they are a business or a consumer
- The VAT number (if provided)
- The amount charged
- The VAT charged
- The VAT rate applied
- The evidence collected (IP address, mobile number token etc.)

As I mentioned earlier, we outsourced that part to Taxamo. We are pushing information about the EU VAT exception areas into a free form field.

4.6 Handling of digital and non-digital products

Are you selling digital and non-digital goods? Then there is a nice surprise for you: non-digital products and services are still subject to the “old” VAT rules (i.e. where the place of supply is still where the vendor is based). Hence, if your store features digital and non-digital products, you will need to calculate the VAT separately and also show them individually on your invoice. If you are
selling product bundles you will need to break them up and calculate the VAT accordingly for the
digital and non-digital goods. Sounds like a lot of fun, doesn’t it?
This is not an issue for us but I imagine if you are in this situation this will add to the complexity of
upgrading your payment system. If you are using a 3rd party marketplace make sure they are able to
handle this complexity; especially if they are not EU-based they might not know about this yet.

4.7 Administrative overhead for small merchants

Many small merchants so far fell below their country’s VAT threshold and were not obliged to
register for VAT. With the new regulation every merchant selling digital products and services online
that fall under this new regulation needs to register for VAT. The resulting administrative overhead
threatens the commercial viability of these businesses. Apparently some smaller merchants with
low sales volume consider the introduction of some manual steps into the delivery process to get
around this new regulation.

4.8 Non-discrimination

Companies might think that one way to avoid the hassle of implementing the new EU VAT rules
would simply be not to sell to certain EU customers anymore. However, there is a legal opinion – and
I am unsure how solid that is – that states that companies could be found to be in violation of EU
non-discrimination regulation if they sold digital products online and effectively excluded certain EU
customers because of their place of residence. That opens a whole new can of worms, which we
would rather avoid.

4.9 Data privacy

Another interesting aspect is the question of data privacy. Tax authorities provide relatively clear
guidance on the type of information that should be gathered as evidence. However, generally, the
rules on data privacy in the EU and in particular in countries such as Germany are very tight.
There is an interesting debate going on about the legality of capturing and storing personal data
such as the IP address for a period of 10 years, which is the period for which the VAT records need to
be kept.

4.10 Global impact

Apparently largely unknown to many the EU VAT rules in place since 2003 require non-EU vendors
selling to EU consumers were to charge the their customers the buyer’s local VAT rate and pay it to
the respective EU country’s tax authority. Apparently, those non-resident vendors can now also
benefit from the MOSS system by registering with tax authorities in a EU country of their choice. I
wonder how many Indian, Chinese or US merchants have registered for EU VAT, and how the EU tax
authorities plan to enforce this rule. Good luck with that one!
5 Why on earth did they do this?

Well, good question. If rumours can be trusted this is kind of a Lex Amazon. Amazon and other US online giants located their European digital business in Luxembourg to take advantage of the low VAT rate there. The other EU member states wanted a piece of the 1.1 billion EUR p.a. VAT revenues and tried to find a way to make Amazon et al pay a fair share to all EU member states.

So, the new regulation means a big shift of VAT revenues from Luxembourg to the other 27 member states. You might say, ‘fair enough’ but it doesn’t end here: Of course, Luxembourg complained about losing out on VAT revenues, so in order to stop the country blocking the new regulation the other EU member states agreed to pay Luxembourg 1.1 billion EUR p.a. for the next four years to compensate for the expected loss. However, that was not enough, so Luxembourg now decided to raise its own VAT rate to 17%.

And that’s where I really don’t get it anymore - but I probably simply do not comprehend the brilliance of our EU and national tax bureaucrats. Obviously it was possible to find a pretty simple way to compensate Luxembourg for their losses. If the original task was to redistribute some about 1.1 billion EUR p.a. n VAT revenues between EU member states why could nobody come up with a solution that would not create a massive headache for Europe’s online businesses?

It seems to the EU VAT 2015 regulation is somewhat of a Rube Goldberg machine – a “machine that is deliberately over-engineered to perform a very simple task in a very complicated fashion”.

6 Here is what we did

Due to the nature of our service we always have an address for our customer. However, at the beginning of the purchasing process the customer may change the billing address.

6.1 Determine if the buyer is a business or a consumer

On the next screen we check whether the customer has a valid VAT number for the billing address. If the customer previously provided a VAT number we show the tab “EU VAT registered”, if not “Non EU VAT registered”. At that point the customer can easily go to the other tab “EU VAT registered” and enter his VAT number.
The EU’s new Rube Goldberg machine: EU VAT 2015

Image 2 VAT number entry

If the customer does not provide a valid VAT number we start the verification process after the user clicks on “Verify Now”.

Image 3 VAT details - Verify now
6.2 Determine the buyer’s place of residence

We first check the customer’s IP address against the billing address country. If that works out we confirm the place of residence and apply the correct VAT rate.

If that step fails we move on to text message-based verification of the customer’s mobile number. Again, Taxamo provides this feature.

![Image 4 Mobile number verification](image)

In case mobile number verification is not possible or the verification fails we allow the customer manual self-certification as a fall-back solution. In this case we ask the customer to confirm his country of residence.
6.3 Handling of EU VAT exception areas

We also check whether the billing address provided is located in one of the EU VAT exception areas; we check against a list of the country’s states or provinces, or in the case of towns against postal codes. If applicable we check the IP address for plausibility and move on to self-certification.

We ask the customer to confirm not only the country of residence but specifically the EU VAT exception area. In the example below that area is Ceuta in Spain, which is also VAT-exempt.
6.4  Apply the correct VAT rate

Image 7 VAT confirmation
7 EU VAT exception areas

In the following table we show the EU VAT exception areas, how we identify them and what the impact on VAT is.

<table>
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<th>Country</th>
<th>State/Province</th>
<th>Territory type</th>
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<th>Territory details (value =)</th>
<th>EU VAT implications</th>
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8 Disclaimer

It took us many days plus several discussions with our accountant to understand the problem and identify a viable solution. I am sharing our views and solution to the best of our knowledge and as a basis for you to start your own process of getting ready for the EU VAT 2015 changes.

At this point I would like to stress the fact that I am neither an accountant, nor a tax advisor, nor a lawyer and that the views expressed in this post cannot be considered legal advice. I strongly advise you to discuss this matter with you accountant or tax advisor.

If you discover any error in our approach I would be more than grateful if you could let us know.
9 Further reading

In case you want to get deeper into this, here is a list of resources we found and used in our research. Since we are a UK-based company some of the documents have been provides by the HMRC, the UK tax authority. There is a high chance that your local tax authorities might provide their own guidance.

9.1 European Commission (EU) resources

VAT rates
Explains the different VAT rates in the EU members states
http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/rates/index_en.htm

Telecommunications, broadcasting & electronic services
Explains the scope of the new VAT rules
http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/telecom/index_en.htm

VAT Rates Applied in the Member States of the European Union (PDF)
Explains the VAT rates in the EU member states and outlines the VAT exceptions

Annex 1 to SAD Guidelines (TAXUD/1619/08 rev. 3.4): Overview of European Union countries (PDF)
Provides detailed overview of the EU VAT and customs exception areas

Explanatory notes on the EU VAT changes to the place of supply of telecommunications, broadcasting and electronic services that enter into force in 2015 (PDF)
Explains the scope of the new EU VAT regulation, especially what services are affected

Questions & Answers: VAT changes from 2015
EU press release providing some high level answers to the new regulation

9.2 HMRC (UK) resources
VAT: businesses supplying digital services to private consumers:

VAT Notice 725: the single market

9.3 3rd party resources

2015 EU VAT changes to electronic B2C services
Explains the scope of the new VAT rules

Special member state territories and the European Union
Further background on the EU VAT exception areas (helpful to understand the nature of the exception)
http://en.wikipedia.org/wiki/Special_member_state_territories_and_the_European_Union
10 About

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