

## Answered calls

Ruairi Quinn, Minister of Finance, Ireland

To the ordinary European citizen the appropriate rate of VAT to apply seems an abundantly simple concept. In France, French VAT should apply, in Greece, Greek VAT. In reality, relatively complex rules have to exist to decide this question. To deal with VAT on the provision of services in particular, the Sixth VAT Directive<sup>1</sup> has lengthy sections intended to cover this complicated area with rules concerning the 'place of supply'. It is always dangerous to summarize but the basic rule for services (set out in Art. 9.1 of the Directive - with many exceptions following in other sections) is that services are deemed to be supplied where the supplier has established his business or has a fixed establishment from which the service is supplied or, in the absence of such a place of business ... the place where he has permanent address or usually resides.

The Council has just made a very significant addition to those rules to cover developing problems in the area of telecommunications services. These were not foreseen when the Directive was originally adopted. Changing technology and the liberalization of the EU telecommunications market has created new options and a new tax problem which the Council has now addressed and agreed to resolve by unanimity. Who said that EU tax problems could not be agreed by unanimity?

I do not believe that this will be the last occasion when EU tax collection has to adapt to the changes in the cross-frontier provision of services that technological or regulatory changes make possible. Developments in electronic commerce, unforeseen when the VAT rules were originally drawn up, may force other changes in the future as EU Ministers move to defend their traditional tax revenues against erosion.

Until recently, telephone services in EU states were provided by single suppliers, often a state monopoly. If you wanted to use another supplier you had to drive across the border, where another company, often not too different in overall outlook and approach, provided telephone service. In such a captive market, there was little or no ambiguity about the place where tax applied and the VAT rate that was to be applied.

The first wave of competitive change in the opening up of the EU telecommunications markets, and the development of competition in national markets with the emergence of companies such as Mercury in the UK, made little difference from a tax competition point of view. Second, national telecoms operators or new mobile phone operators introduced competition to the

marketplace but also applied the same local tax rates to their customers as did the original service providers. They had no VAT advantage.

Only recently have the technological and regulatory conditions allowed the provision of telephone services in the EU by firms that, for VAT purposes, were considered to be non-resident and did not have to apply the local VAT rate. Indeed, these firms were typically located in places such as the USA, where no VAT was levied at all. (The US operates no federal tax on sales of goods and services while VAT is an obligatory tax in the EU. Many, but not all, US states have local sales taxes at differing, fairly low rates.) These competitors could then supply EU customers, making calls out of the EU, entirely free of VAT or equivalent tax. This is a considerable marketing advantage, given that EU VAT rates can add up to 25 per cent to a telephone bill. The Irish VAT standard rate is 21 per cent, for example.

There are a number of differing ways this alternative international call service can be provided using the new switching technology and leased lines. One common mechanism was to use a 'callback' arrangement where dialling a local number in your home state (sometimes a free phone number) then automatically prompted a return call back to your home number from the service provider in a foreign country. This open line could then be used to complete your international call, as required. It might be cheaper anyway if national phone companies had high charges but it was also probably tax-free! The supplier was, for VAT purposes, not resident in the country where the caller was located for the purpose of Art. 9 of the Sixth Directive. The calls were either prepaid in advance or billed from abroad. Often the only presence in the state was a piece of telephone switchgear.

Not surprisingly, local telecommunication services providers were at a substantial tax-based disadvantage and the tax authorities began to get calls about this tax 'loophole'. Why should a local service provider, which may have had other costly public service obligations to meet, have to charge one rate of VAT, while a similar service provider from abroad would escape both the obligations and the tax burden? Please, Mr. or Ms

<sup>1</sup> Directive 77/388/EEC. This Directive was originally adopted in 1977 but it has been modified on several occasions since that date, most notably with the changes needed for the introduction of the EU Single Market.

Finance Minister, let us have a level playing field, they asked.

There were some basic ways to solve the tax competition problem. One was to persuade all other states in the world to impose VAT or similar taxes in a similar manner on telephone services. This did not appear to be an option likely to lead to an early and satisfactory answer. A second option, reduce VAT on telephone services to zero in Europe to compete, was equally unlikely to gain acceptance. European Finance Ministers need the tax revenue, especially as they seek to cut the debt burden to prepare for Economic and Monetary Union.

It was necessary to find a mechanism to make this type of service taxable in the EU, one that applied when the service provider was non-resident. This latter option was the subject of intensive discussion by tax experts with the European Commission over the last year which has now led to a measure being agreed to close off the 'loophole'.

The solution that has now been adopted, on an interim basis for reasons of speed, makes the transaction subject to VAT, and it uses an extension of an existing formula in the Sixth VAT Directive, commonly and very appropriately in this case, called 'the reverse charge mechanism'.<sup>2</sup> The customer, if a business customer, not the supplier of a service, now

takes centre stage and assumes new tax responsibilities.

The basics of the solution are set out in a series of near identical derogations made under Art. 27 of the Sixth Directive, one for each EU Member State, but they are in essence very simple. If firms are using such a service provider in future, the call that the EU tax authorities will now make to them is please let us have our VAT at our national rates on this service. No longer can the firm avoid VAT, just by choosing a non-EU supplier for international calls, over a national service provider. If the supplier outside the EU supplies the service to private consumers here, the supplier will have to register for VAT purposes.

In Ireland these new provisions will apply from 1 July 1997 in accordance with the provisions of the Finance Act 1997. Some EU members have taken action already in their national legislation or regulations, in advance of the derogations being agreed at EU level, to close off the loophole in this way from an earlier date.

<sup>2</sup> 'Reverse charge' in common English usage is where telephone calls are paid for by the recipient not by the calling party, as is normal!