



Assessment of the application and impact of the optional 'Reverse Charge Mechanism' within the EU VAT system

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*Executive Summary
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Executive summary

Introduction

A reverse charge mechanism has been implemented in Member States' legislation in a number of specific cases as an "anti-fraud tool" in certain sectors that are vulnerable to fraud. In addition to measures that are based on derogations granted by the EU Council in accordance with Article 395 of the Directive 2006/112/EC (hereafter "VAT Directive") or the standstill provision of Article 394 of this Directive, Member States can apply the reverse charge mechanism, under certain conditions, to sectors or types of transactions that are enumerated in Articles 199 and 199a of the VAT Directive.

Although the reverse charge mechanism may be useful in tackling fraud in certain sectors of activity, its specific features remove other advantages which the standard 'fractionated payment' system may bring via the collection of the output VAT at each stage.

Consequently, the application of the reverse charge mechanism may give rise to some additional administrative obligations for businesses – ranging from specific reporting in the VAT return to the filing of additional specific forms – in order to ensure the correct collection of the VAT by means of cross-checks between data reported by both parties to a transaction.

Identification of Member States that make use of the options to apply a reverse charge mechanism

The first objective of the study is to identify the exact scope of the application of the reverse charge mechanism in each Member State under Articles 199 and 199a and/or on the basis of derogations granted in accordance with Articles 394 and 395 of the VAT Directive and to describe the main features of the applied mechanisms.

The results show that recourse to the reverse charge mechanism has increased over the last months but that the waste sector (twenty three Member States), transfers of allowances to emit greenhouse gases (twenty one Member States), and the construction sector (eighteen Member States) remain, by a long way, the sectors where the reverse charge mechanism has been most widely implemented across the EU.

Our survey of the main features of the optional reverse charge mechanism implemented in Member States legislation shows a generally low or medium complexity involving fairly limited administrative obligations except in three Member States. In these latter Member States, the number of sectors in which the mechanism is applied and the different conditions specifically laid down for each of the sectors give rise to what can be considered as a relatively high degree of



complexity. Businesses in the relevant sectors are in most Member States required to apply the mechanism but in a few Member States, this is only once a certain threshold is exceeded.

Evaluation of the economic importance of the reverse charge mechanism

The second objective of the study is to evaluate the importance of the reverse charge mechanism in terms of taxable basis, compared to the overall economy measured in terms of the Gross Value Added (GVA) of the Member State concerned.

Our analysis shows that in about half the Member States (sixteen), the estimated revenue generated from activities currently subject to a reverse charge mechanism represents between 1% and 4% of their respective overall economy i.e. GVA. There are however some Member States (nine) where the application of the reverse charge mechanism is more limited and a few (three) where the application is wider. The average for all Member States is 2,17% of GVA. The construction (1,35%), waste (0,44%) and cereals (0,26%) sectors are the most important in terms of estimated generated revenue amongst all sectors subject to the reverse charge.

On the same basis, we examined a scenario in which all Member States would apply a reverse charge mechanism to all sectors listed in Articles 199 and 199a or for which a derogation has been granted based on Articles 394 or 395. Under this scenario, our analysis shows that the estimated revenue which would be generated from the sectors concerned compared to the overall economy would range between 2% and 7% of GVA in the majority of the Member States (twenty three). The average for all Member states would be 4,99% of GVA. The main contributors are the construction (2,05%), waste (0,76%), gas and electricity (0,61%), telecommunication (0,60%), cereals (0,54%) and metal (0,41%) sectors.

We have also evaluated the importance of the reverse charge mechanism in terms of VAT receipts compared to the total VAT receipts in each Member State. Our analysis shows that for about half of the Member States (seventeen), the estimated VAT generated from transactions subject to the reverse charge mechanism compared to the overall VAT receipts of the Member States concerned ranges between 2% and 10%, with an overall average of 4,60%. The Member States for which the importance in terms of taxable basis is high are also in the highest range in terms of VAT receipts, which shows that the importance of the sectors concerned is the main driver rather than the level of VAT rate applied.

Finally, we projected the importance of the reverse charge mechanism in terms of VAT receipts under the hypothesis that all Member States would apply a reverse charge mechanism to all sectors listed in Articles 199 and 199a or for which a derogation has been granted based on Article 394 or 395. This analysis shows that for the majority of the Member States (eighteen), the estimated VAT generated



from transactions which would be subject to a reverse charge mechanism compared to total VAT receipts would range between 5% and 15%.

The results of our calculations on the importance of the reverse charge mechanism of the Member States are summarized in the table below:

| Importance (average of all MS) in terms of taxable basis (GVA) of applied RCM | Importance (average of all MS) in terms of taxable basis (GVA) of all RCM | Importance (average of all MS) in terms of VAT receipt of applied RCM | Importance (average of all MS) in terms of VAT receipt of all RCM |
|---|---|---|---|
| 2,17% | 4,99% | 4,60% | 10,95% |

Evaluation of the cash-flow impacts of the reverse charge mechanism on Member States

The first part of the third objective of the study is to evaluate the cash-flow impact of the current application of the reverse charge mechanism and the cash-flow impact of the possible generalised extension of the reverse charge mechanism in all Member States. This estimate takes into account the VAT return filing periodicity, the respective volume of VAT returns filed under each of the periodicities in Member States where different filing periodicities exist, as well as the filing deadline. It has been assumed that the VAT refunds/payments are made when the return is filed and invoices are paid 30 days after the date of receipt.

Our analysis of the estimated cash-flow cost for the Member States due to the current application of the reverse charge mechanism expressed in percentage of the total VAT receipts shows that for twelve Member States the estimated cost ranges between 0,0050% to 0,0200%. The four Member States for which the estimated cost is higher are either States where the application is wide or/and where the VAT return filing deadline is long. Moreover, the Member States where VAT returns are primarily filed on an annual rather than periodical basis tend to be more influenced by cash-flow impact than the Member States where annual VAT returns filing has not been implemented. The average has been estimated at 0,01067%. At an EU level, the construction sector is, by far, the most impacted in terms of cash-flow by the currently applied reverse charge mechanism.

Our analysis of the estimated cash-flow cost which would be induced by an extension of the currently applied reverse charge mechanism to an application for all sectors - expressed in monetary value - shows that in the large majority of Member States, the estimated monetary cash-flow impact after extension stays below 10 mil EUR. The impact of the extension is obviously more important in Member States which do not currently widely apply the mechanism and especially those which do not apply the mechanism in sectors which are important compared to their overall economy and those which have longer VAT returns filing deadlines.



Analysis of the administrative burden of the reverse charge mechanism on businesses

The final part of our analysis which concerns the administrative burden of the reverse charge on businesses is based on information provided by a small sample of businesses in six different Member States (Hungary, Slovenia, Lithuania, the Netherlands, Italy, and the UK) representing a mix of small, medium and large enterprises, as well as representatives from different industries that are subject to domestic reverse charge mechanism compliance in these Member States. It should be noted that given the agreed small sample size, these figures may not be representative for businesses in general.

Methodology

Structured interviews were used for collecting relevant data from businesses. The analysis was based on "Activity Based Costing" (ABC) methodology, which uses "time spent on compliance activities" and "cost per hour" for businesses to quantify the VAT burden (both due to reverse charge mechanism application and other VAT procedures). We then compared cost data to trade (sales and purchases) and turnover in order to normalize the inherent differences across businesses and compare results.

The results from the surveys are summarized below:

Impact on ongoing administrative costs in relation to other factors

The introduction of the reverse charge mechanism means that businesses incur some ongoing administrative costs. These costs have been analysed in terms of number of full time equivalents employed by the business and activities/time spent by staff for VAT compliance. The results are summarised in the table below:

| | Ongoing costs as a % of turnover | | On-going costs as a % of trade ¹ | |
|--------------|----------------------------------|----------------------|---|---------|
| | RCM ² | Non-RCM ³ | RCM | Non-RCM |
| SMEs | 0,75% | 0,71% | 0,38% | 0,35% |
| Large | 0,33% | 0,17% | 0,16% | 0,09% |
| Total | 0,43% | 0,30% | 0,21% | 0,15% |

The ongoing compliance costs of the optional reverse charge mechanism are on average in the region of **0,21%** of the total reverse charge mechanism trade

¹ Trade = Sales + Purchases

² RCM refers to the average compliance costs of a business that is mandated to comply with RCM VAT rules.

³ Non-RCM refers to the average compliance costs of a business which is not mandated to comply with RCM rules. It was calculated on the basis of the non RCM costs of the businesses in the sample for their trade in non RCM goods.



profile of businesses (trade profile is defined as sum of sales and purchases). Reverse charge mechanism compliance rules increases business costs to **0,43%** when expressed as a percentage of business turnover and the difference between reverse charge mechanism and non-reverse charge mechanism compliance is **0,13%**⁴. This represents for this sample an **increase of the compliance costs by 43%**.

Within the survey sample, business size appears to be an important determinant of the VAT compliance cost burden. In particular, the reverse charge mechanism increase in compliance costs is much more limited to SMEs in comparison to large enterprises, although the general compliance costs are in general higher for SMEs.

An additional analysis that we included was a comparison of employees that are responsible to handle general VAT compliance tasks against those who deal with reverse charge mechanism activities of any kind. The results indicate that small businesses where administrative activities are often undertaken by the same employees involve a higher proportion of their staff in dealing with reverse charge mechanism activities in comparison with large enterprises.

EU level analysis

The results presented above are based on a limited sample of businesses. However, if we assume that the figures calculated above are representative for the overall EU population of firms, this implies that the reverse charge mechanism results in additional 0,13% compliance costs as a percentage of turnover, which represents an **increase by 43% of compliance costs**.

If we then extrapolating this figure to the overall estimated revenue generated from activities currently subject to a reverse charge mechanism i.e. GVA at EU level (**2,17% of GVA** as presented in section 2 of the report), this would imply that reverse charge mechanism compliance creates an **additional burden of EUR 323m or 0,003% of total GVA**. If that figure was to be extrapolated to 100% of trade (same level of compliance costs on the whole economy), that would almost represent 15 bn euros.

This means that the reverse charge mechanism is likely to have, as it is applied today in an optional and non-harmonised basis, major implications on compliance costs for businesses. This does not, of course, mean that it would generate similar costs if actually applied on a generalised and harmonised basis.

⁴ This figure is broadly within the range of other similar studies (e.g. 'A retrospective evaluation of elements of the EU VAT system') done previously on VAT administrative burden. Ongoing compliance costs in absolute figures are higher than figures presented in other reports, but we noted that this is caused by the inclusion of Finance and Utilities sector representatives within our sample.



Other key findings

Our analysis also sought to investigate implementation costs associated with the reverse charge mechanism, cash-flow impacts for businesses and to gather information from businesses about dealing with domestic rules in other Member States. We also collated some additional qualitative feedback from businesses about the application and impact of the reverse charge mechanism which are summarised below.

Businesses subject to reverse charge mechanism incur initial implementation costs when the compliance rules are first introduced. We collected information from businesses about their one-off costs in cases when this has happened after 2009 for ease of collection of historical data. This considerably reduces the sample size of the business respondents. The results indicate that on average 0,01% of overall trade represents implementation costs (0,02% of business turnover). The results also suggest that while SMEs have higher ongoing compliance costs, they spend less in upfront implementation investment.

Some qualitative information was also collected from businesses about the cash-flow impact the reverse charge mechanism has on business. The majority of business respondents do not consider the application of the reverse charge mechanism to create any cash-flow issues for their business. Similarly, most of the businesses within our sample do not have to deal with domestic reverse charge mechanism in other Member States, while those who do, did not report any difficulties in doing so.

Some additional qualitative feedback on the application and impact of the optional reverse charge mechanism was collected from businesses within our sample and representatives of businesses across Europe. Our aim was to collect data that represents large enterprises, SMEs and Self-Employed businesses.

A concern was expressed regarding the lack of uniformity in the rules across Member States, due to the varying implementations of domestic reverse charge mechanism in different jurisdictions and differences in the systems used by authorities in the recognition of eligible goods/services. The issue is further worsened by differences in, often unclear, VAT compliance guidelines and the existence of thresholds for reporting.

The reverse charge mechanism appears to be a useful tool for fast and effective prevention of fraud and there is evidence that some authorities have implemented the rule to tackle existing issues in some industries. Even though some businesses are happy with the rule, others have expressed the view that combating fraud and detecting fraudulent businesses could be achieved in other ways. Businesses suggested that the current system may have caused the spread of fraud to other sectors in the economy and other countries.



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