

## TIP OF THE WEEK

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### VAT attack: What you don't know *will* hurt you

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In this global economy, virtually every software company has users in countries outside its own. The combination of the internet and electronic delivery allows every ISV to be a global player from the get-go.

But while it's tempting to consider the entire planet as one market, value-added tax (VAT)—especially in the European Union (EU)—is a harsh reminder that we're still operating in the equivalent of medieval fiefdoms.

"If you distribute software and do subcontracting overseas, you're going to generate VAT charges," says Chris Walsh, VAT practice leader for tax software developer **Vertex**, based in Berwyn, Pa. "120 countries around the world employ a VAT or VAT-derived system."

#### **The consequences for software sales**

And if you don't collect VAT on your software sales? "Originally, the EU was making all sorts of threats, including saying they'd not recognize your trademark and patents," Walsh says. "They've never recanted that.

"They also made claims that if there were any assets they would freeze them, or arrest any employees on the ground in the EU. None of that has actually happened, to the best of my knowledge, but the idea that your copyrights might not be recognized, and open yourself up to a form of sanctioned piracy, is a pretty large incentive to obey."

And, there's one more incentive, in the form of a future skeleton in the closet: If you don't collect VAT now, your liabilities carry forward—they never go away. Thus, any merger or acquisition conversations carry a new wrinkle: Your non-payment of VAT will come out as part of due diligence.

Here are Walsh's recommended steps for dealing with the VAT bogeyman:

**VAT step #1: Make a decision on where you intend to market your software and services.** "VAT is one of the first things you have to consider," Walsh says.

It may sound nuts, but the VAT proposition is serious and scary enough that you may elect to not sell outside the U.S. "That's certainly a possibility," Walsh says. "It comes down to an assessment of business risk; there is a cost involved in complying with EU legislation.

"At a minimum, it requires employing an accountant somewhere in Europe to run the process for you—and even if you outsource the whole thing, you're not talking about a small cost.

"In addition, you'll have a hell of time getting any of them to guarantee their results—if they slip up, the liability still comes back to you. They'd do the work, and do their best to get it right, but I don't think any would give you a guarantee.

"Ironically, the risk is much less if when selling to non-EU countries. Many of them are looking at it and deciding how they want to structure their legislation, and, second, the practicality of payment enforcement. I don't expect this problem to go away."

**VAT step #2: Figure out which of your products and services are is subject to VAT.** Remember, it isn't just software that's subject to VAT.

"Most services attract VAT," Walsh says. "There are exemptions for education, but that's normally of the type provided by a school or university, not corporate training.

"VAT applies if the training is automated and dependent on the internet or similar electronic network to function, including virtual classrooms, but not if you're providing interactive training services where the course content relies on substantial human intervention.

"In other words, if you're simply using the internet as a means of delivery, you should be OK from a VAT standpoint, but recorded webinars would probably be subject to VAT.

"Software is always subject to VAT, regardless of delivery method. Tech support is also subject. If you gave it away as a free upgrade, no, but if you're charging for it, it will attract VAT.

"Training materials will also attract VAT. Whether sent through the customs import process or downloaded, the amount charged is subject to VAT."

If you're selling your software on a subscription license, you'll want to think about how you charge customers who are subject to VAT. It's your invoice that triggers VAT, not the contract amount.

So, for example, if you collect money from your consumer end-user every month, you'll have to collect and report VAT every month—a lot of paperwork. If you invoice the full amount for, say, a year's subscription, you'll have less filing to do, but take a heavier upfront hit.

**VAT step #3: If you're going to sell to the EU, choose one country to register in.** This becomes your "clearing-house" for the collection and payment of VAT.

"Last year, the EU brought in a directive regarding the registration of companies that provide digital downloads to EU customers," says Walsh. "They introduced a simplification, so that you could register with one country.

"Strictly speaking, you should register in every country where you have a customer; if you have people downloading in 25 EU countries, you have to register in all of them.

"Under the simplification rule, you pick the one you want—not necessarily the country with the lowest VAT—but you still have to account for the VAT according to the location of your software or services customers.

"The simplification is just in the number of forms: You're submitting one set of filings. The country where you're registered will collect your payment and distribute it among the relevant countries."

Because of language issues, probably the easiest point of registration for most U.S. developers is the U.K., Walsh says. "But if you have your own people somewhere in the EU, you will likely want to register where they are.

"One of the quirks is that if you already have a VAT registration somewhere in Europe —prior to July 1, 2003 —you're not entitled to use the simplification registration; you have to register in all 25 countries.

"The scope of the simplification is very narrow; it really only addresses the issues of those who are moving in for the first time. For those who are already there, it really hasn't helped them at all.

**VAT step #4: Establish clean communication with the person you appoint as your VAT agent in other countries.** "You don't want to be bothered with this on a day-to-day basis," Walsh says.

"Most companies here don't want to become experts in VAT—but it's very important that the other person understand exactly how you're doing business.

"Someone in the U.S. is going to have to record the numbers, and it's unlikely your accountant in Europe will have access to those numbers. So, you'll need some kind of revenue system that identifies revenue and tax by region."

How do you find your VAT expert? "Most U.S. accounting companies have some sort of international affiliation," Walsh says. "Even relatively small firms are members of international associations, and they should be able to refer you."

**VAT step #5: Set up some kind of country identification for all your sales.**

Where are the download requests coming from? Proper reporting, with all the data elements, is vital.

**VAT step #6: Set up some kind of VAT declaration as part of the purchase process.** For example, you might have a VAT registration box on your shopping cart page, where you ask the customer to enter their VAT number.

If they're a business and therefore handle VAT accounting on their end, you're off the hook. But if they don't enter a number, you must assume it's a consumer sale that's subject to VAT—and you're obligated to collect the tax.

"There are online tools that enable you to verify the VAT number is genuine, but it won't tell you what rate to charge," Walsh says. "You need to know what the 25 different rates are, and which you should be charging. The simplification really hasn't made it that simple."

**VAT step #7: Stay on top of VAT issues through reading, research.** Because it's influenced by politics, this subject area is moving and amorphous, and you need to stay current.

"In the U.S., there's a great amount of debate about how you tax state downloads, and the same discussion is going on around the world," Walsh says. "You can reasonably expect within the next year or two to see legislation similar to the EU's cropping up in other places.

"Unfortunately, there are very few reference guides to global VAT. The best bet is international tax magazines; the 'International VAT Monitor,' published by **IBFD** in Holland, is a good one.

"There are also some online products. For example, [GlobalVatOnline](#), run by **PricewaterhouseCoopers**; they charge €500 per year for a single subscription."

Walsh modestly failed to mention that he also wrote an excellent white paper on the topic, called "[The Changing Face of Value Added Tax](#)." It's free, but you do have to register on the Vertex site.

Finally, you might take a look at the U.K. VAT authority's site that deals with digital downloads, e-services, and registration; the FAQ section is pretty good.