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In this article, the author discusses the VAT reforms proposed by the European Commission, focusing on the effect the proposals will have on corporate tax functions and the need for tax technology in the European Union.

"You keep using that word. I do not think it means what you think it means."
— *The Princess Bride*

One of countless memorable lines in the cult comedy *The Princess Bride*, the opening quote reflects one character questioning another's repeated use of "inconceivable" to describe a confrontation that is not only possible, but that swiftly comes to pass. For the past 25 years, the same statement could also have been used to remark on the European Commission's use of "transitional" to describe VAT rules that were put in place in 1993 — and remain in force today. That may not be the case for much longer, however, thanks to the all-encompassing package of VAT reform proposals that the commission unveiled in a in early October. The first line of the commission's announcement promotes the change as "the biggest reform of EU tax rules in a quarter of a century."[1] What for two-plus decades was "temporary" is now poised to become transformational.

The proposed reform, which applies only to business-to-business (B2B) transactions and initially only to goods, certainly qualifies as a major shift. The most noteworthy changes include:

- a shift from an origin-based system to a destination-based system;
- tasking B2B vendors with the responsibility to charge and collect VAT; and
- a major expansion of the EU's mini one-stop shop (MOSS) web portal, previously used on a far more limited basis for VAT payments on electronic services.

The commission's VAT reform release also lists the primary reasons behind the EU VAT system reform:

- addressing the more than €150 billion in VAT revenue that member states are owed but fail to collect each year (due to fraud and other reasons);
- simplifying and modernizing VAT rules across the EU; and
- reducing the compliance burden and related costs imposed on companies that conduct cross-border trading.

From a corporate perspective, adjusting to this kind of reform will require far-reaching efforts. Although much of that work will fall squarely on the tax function, the initial effects of VAT reform also will extend to other corporate functions.

The proposed reform package, which is part of the commission's multi-pronged VAT action plan, is likely to change at least somewhat given the numerous procedural steps — and the potential political obstacles — that lie ahead. However, early signs suggest that the overhaul stands a

[1] European Commission release on reform of the EU VAT system (Oct. 4, 2017).

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good chance of being finalized. The commission hopes to have a new VAT system in place by 2022, with the bulk of the technical enabling work occurring in 2018.

Company tax leaders and their staff should monitor all of the initiatives within the commission's VAT action plan, including the most recent proposals. As they do, they should keep the following in mind:

- This proposed reform represents a massive change from the current VAT system. It will have major effects on companies, their tax management processes, and their tax technology requirements.
- This is the first of two sets of proposal packages. Although final approval is not assured, the magnitude of the proposed changes signal that companies and tax departments should be prepared for major VAT regime changes.
- The proposed EU VAT reforms will pose numerous challenges to tax departments while also reverberating beyond the tax function. The state of a company's tax technology, in particular, will play a pivotal role in determining the ease and efficacy of the entity's transition to the new system and its ability to comply with new rules.

After summarizing the most important aspects of the proposed reform, this article takes a closer look at the implications of the reforms and examines the tax management and tax technology challenges likely to arise in the course of the overhaul.

1993 vs. 2022: A Snapshot of a Future VAT

Fragmented and complicated may be the two most common descriptions attached to the current EU VAT system.

That's not surprising considering that the system was implemented in 1993, shortly after the creation of the EU's single market, years before e-commerce began to flourish, when the digital transformation of companies was in its infancy, and before the globalization of business passed the tipping point.

The first European VAT directive was implemented in the late 1960s to replace turnover taxes that were cumulative and often slowed the movement of goods across national borders. Although there have been several changes made to those initial VAT rules, none have addressed the dramatic transformations in digital communications and global commerce that have occurred in the 40-plus years since then.

Today's EU VAT rules date back to 1993, when the origin-based system was instituted on a (theoretically) transitional basis. When a company in one member state sells goods to a company in a second member state, VAT is not added because cross-border transactions are exempt from VAT. However, VAT on that transaction is paid to the treasury of the second member state by the buyer upon acquisition using a self-assessment. Subsequent sales of those goods in that member state is subject to the VAT rules of that country. This frequently results in a complex series of events in which VAT is sometimes added to the sale price and sometimes the sale is exempt, creating a chain of transactions, with each transaction potentially affecting the VAT treatment of those that follow. Consider the challenges posed by a case in which goods are produced in one country and sold to a company in a second country, which wants the goods drop-shipped directly to a customer in yet another country, which may or may not be the goods' final destination.

"Twenty-five years after the creation of the Single Market, companies and consumers still face 28 different VAT regimes when operating cross-border," Pierre Moscovici, the EU's commissioner for economic and financial affairs, taxation and customs, said upon the release of the new VAT system proposal package in October 2017. He also asserted that the current "anachronistic system based on national borders must end."[2]

The commission proposes transforming the EU into a single VAT area within its single market. Most notably, the EU VAT would shift to a destination-based system. VAT on cross-border sales would be charged by the vendor at the VAT rate of the member state where the purchasing company is based. Goods sold from one member state to another member state would — in principle — be taxed the same way goods sold

[2] *Id.*

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within member states are taxed. The vendor would use a single VAT return to pay the VAT to its own country's treasury at the rate of the destination country.

The commission organized the four foundational principles of the new VAT system into a list of headings that describe what the new VAT system will do (tackle fraud), what it will provide tax authorities and companies (greater consistency and less red tape), and how VAT payments will be submitted (using a one-stop-shop mechanism).

These are the high-level aims of the reform. Now, the commission must seek a unanimous agreement from the member states for the detailed proposal to become EU law. Four quick-fix recommendations are also included in the commission's directive in October (see side bar). The commission is expected to propose a second VAT reform directive sometime this year detailing how the four principles (or cornerstones) will be implemented and identifying all transitional articles that will be replaced or deleted.

More work, including substantial IT-related work on the one-stop shop and other aspects of the new system, will be needed before the system would be ready for implementation.

Four Short-Term Fixes

In addition to the comprehensive overhaul of the EU VAT system proposed in October, the European Commission identified four "quick fixes" designed to improve the existing VAT system until a comprehensive new regime can be finalized, approved, and enacted. These proposed short-term measures are:

- Simplification of the VAT rules for companies operating in one country, but storing goods in another country to be sold directly to customers there. This simplification would be limited to certified taxable persons (CTPs) — companies that meet a set of criteria that free them from the need to register and pay VAT in another member state when they store goods there.
- Simplification (also limited to CTPs) for elements of a chain transaction that do not involve the physical movement of goods. For example, this could apply when goods are sold along a chain of several traders but only physically move directly from the original seller to the final buyer.
- Harmonized, uniform rules to allow CTPs to more easily prove that goods have been transported from one EU member state to another.
- Clarification that, in addition to proof of transport, the VAT number of the commercial partner — a number recorded in the electronic EU VAT verification system known by the acronym VIES — is required for the cross-border VAT exemption to be applied under the existing rules.

Six Important Implications of VAT Reform

As the commission has repeatedly emphasized, the proposed reform is massive and historic. Individually, each of the four principles qualifies as groundbreaking. For example, while the one-stop shop sounds like a convenient, user-friendly approach, it will have a sizeable impact on tax-reporting processes within companies.

While the reform remains, for now, in its early stages and it is ripe for revision, tax leaders and their teams should consider the following likely implications of the commission's proposals as they monitor the commission's progress in 2018:

- *The proposed package suggests that sweeping changes to the EU's VAT system are likely, regardless of their final form.* When the European Commission released its draft on October 4, it signaled to the global tax community that it intends for VAT reform — with its dramatic shift to the destination principle — to be historic. Veteran tax practitioners and tax technology experts have seen numerous VAT reform proposals from the commission over the years, but nothing approaching the magnitude of this package, which would have far-reaching effects on most companies doing business in the EU.
- *VAT will be charged on more transactions (including some that are exempt today), and more companies may need to fulfill VAT requirements.* Organizations that trade large volumes of exempt supplies (and therefore exempt numerous transactions) may need to start charging VAT in many countries. Along with some other companies that have not previously paid much attention to VAT management activities, these companies will probably need to reevaluate and revise their strategy. While all companies will need to make process and technology changes in response to the new VAT system, organizations with less advanced VAT

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management capabilities may need to work harder to comply with the new rules and put new processes in place.

- *The proposed one-stop-shop mechanism is a major expansion of the mini one-stop shops already used to manage cross-border VAT requirements for e-services.* The commission acknowledges that "substantial IT developments" will be needed to ensure the proper operation of the proposed system. Much of this technology work will involve the online portals intended to allow companies to submit all cross-border VAT declarations and payments one time, in their home language, and their home country. While a similar system for e-services may be "working well," as the commission touts, that does not mean it is guaranteed to scale well.
- *More tax authorities will be sharing more organizational tax information.* Many multinational enterprises are already confronting the challenges and risks posed by governments sharing tax information with other governments in accordance with the OECD's base erosion and profit-shifting project's country-by-country reporting requirements. Organizations with EU VAT obligations can expect to face further challenges involving additional information sharing by tax authorities as VAT reform progresses. In practice, the EU's VAT reform proposal may go beyond BEPS and other information sharing regime requirements by requiring that VAT data be shared among EU tax authorities, customs authorities, Europol, and other national bodies with anti-fraud mandates.
- *The impact of the new EU VAT system will extend beyond the tax function to other processes and parts of business entities.* Under the proposed VAT system, companies that fail to collect payment on a completed sale of goods to another company (for example, if the buyer filed for bankruptcy after the purchase) will still be required to submit VAT on that sale. This may affect cash reserves at some companies, depending on the credit risks their customers pose, and pose challenges for the accounting and treasury departments. Under a new VAT regime, auditors are likely to intensify their scrutiny of VAT deductions, in turn heightening pressure on companies to ensure that their invoices — and invoicing processes — remain unassailable.
- *Major unknowns remain, many of which could pose new tax management challenges.* As the VAT reform proposal progresses, it will be subject to greater political and public scrutiny, which could result in changes — potentially substantial — to the end product. It also remains to be seen how the new VAT system will interact with changing VAT regulations in individual EU countries. Spain's new VAT-related regulation, the Suministro Inmediato de Información, took effect last summer, and other countries are poised to implement similar regulations in 2018.

Reform's Challenges for Tax Technology

The extent and magnitude of the work, challenges, and risks posed by the implications of VAT reform enumerated above will depend on the quality and flexibility of the tax management processes and tax technology companies have in place when the new EU VAT regime takes effect. These processes and the supporting technology will be put through their paces because the commission has made clear that VAT reform is likely to result in: (1) the application of VAT to significantly more transactions; and (2) more companies of all sizes falling under the scope of the new VAT rules.

When tax rules and rates change, enterprise resource planning (ERP) systems must be updated in a timely manner to comply with the new rules. The scope and difficulty of this change will likely depend heavily on the state of a company's current tax technology.

Smaller companies that are exempt from most VAT requirements under the existing system, but that will need to apply VAT to far more transactions under the new regime, may not have sufficient tax technology in place. These organizations should evaluate their capabilities sooner rather than later and implement suitable tax technology well in advance of the new VAT system's effective date.

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Companies with more robust tax technology systems should also assess their systems to identify how quickly and easily they can be adjusted to support major changes to VAT rules. Depending on how their technology stands on the maturity spectrum, these companies may also need to consider making technology improvements well in advance of compliance deadlines associated with a new VAT system.

Generally, tax technology refers to the rules and data elements in software that allow accurate and compliant tax determinations to be made and, in some cases, reported. In less mature systems, these rules have often been hard-coded in a customized manner into legacy software, such as a homegrown finance and accounting system or a major ERP system, that contains the necessary data elements (orders, customer master data, and so forth). At the more advanced end of the spectrum, separate but integrated tax-specific software contains all applicable tax rules and conducts all of the necessary calculations. This software remains connected to the company's ERP system and related applications that contain all of the necessary data. The so-called tax engine pulls the data it needs to run accurate and compliant calculations from those systems and meet all reporting obligations.

Making changes, even relatively small ones, to hard-coded legacy systems can be a time-consuming, obstacle-laden, and risk-strewn process. The team — or sometimes one individual — that sets up the systems and the tax rules may no longer be with the company, or the system may no longer contain all of the data elements required to conduct the tax calculations that may be required by the new VAT regime. Updating these systems takes significant time and requires careful testing to ensure accuracy and compliance. The challenges multiply when the changes are sizeable and numerous, as they would be with an entirely new EU VAT system.

Changing tax rules with more advanced technology — a modern tax engine — requires much less time and effort while also greatly reducing, if not eliminating, the risk of errors and inadvertent noncompliance. Rather than having to research changing legislation, translating the new rules into IT-compatible language, and managing the change and validation process through the go-live date, companies that use an external tax engine receive all of the changes in a software update.

"Less risk" is the key operative phrase for a change of this magnitude. Managing the skills, process changes, and technology upgrades necessary to comply with the type of reform that the commission has proposed — while simultaneously sustaining compliance with the existing system until the changeover occurs — will require an exhaustive effort. Tax leaders should assess their tax technology capability now, identify potential shortcomings, and focus on closing those gaps well before the new VAT system takes effect.

Major Reform Is Hardly Inconceivable

The European Commission seems intent on reducing the administrative hassles companies endure under today's highly fragmented EU VAT system. Two of the four cornerstones of the proposed VAT overhaul illustrate this intent. The principle of "less red tape" entails simplifying invoicing rules, a goal that would produce many benefits including eliminating the need to prepare recapitulative statements (that is, lists of cross-border transaction) required under the existing system. Likewise, the broader one-stop shop is designed to limit the need for companies to translate information into other languages while also streamlining declarations and payments.

For VAT reform to make good on its promise of simplification and ease, however, significant preparatory work will need to be conducted by the tax professionals in many companies. The promise of less red tape and one-stop submissions is alluring. Making it a reality is not inconceivable, but it will take work. Companies would be wise to begin these efforts sooner rather than later. ■

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