Navigating the EU VAT's Road to E-Compliance

by Peter Boerhof

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In this article, the author examines the use of electronic invoicing and compliance measures for the EU VAT, reviewing the common e-compliance models and examining the challenges and benefits of moving to electronic systems, especially in response to the economic impact of the COVID-19 pandemic.

Even as recently as 2008, businesses in the EU were filing paper returns to satisfy VAT compliance requirements. At that time, only a few countries had begun to use electronic invoicing. Brazil was one of those countries, and its electronic compliance approach was widely considered an anomaly in VAT reporting. Fast-forward to 2020, and e-compliance requirements for VAT — including continuous transaction control (CTC) — seem likely to become the new normal both in and outside the EU.

While this dramatic shift was underway before the onset of COVID-19, the economic distress caused by the global pandemic is likely to accelerate the implementation of e-compliance requirements in most, if not all, EU member states. Thus, it is critical that business and tax leaders understand the various forms of e-compliance requirements, the key factors driving the adoption trend, and the challenges that can complicate compliance with these new rules.

Know Your E-Compliance Models

E-compliance can be defined as the electronic real-time, or near real-time, exchange of transactional data between business and government for the purposes of continuous control and monitoring of compliance. There are five significant models that purport to be forms of e-compliance: periodic transaction detail reporting, near real-time reporting, real-time reporting, central invoice token, and central invoice clearance.

While the models differ, they share one particularly important characteristic: The amount of data and the level of detail that companies share with the tax authorities in all five models extends beyond the content of a traditional VAT return. Generally, all of the sales and purchasing data that are typically found on an invoice must be included in the VAT e-submission.

Periodic Transaction Detail Reporting

In this reporting model, VAT payers must report more transaction details to the tax authorities than they would in a traditional VAT return. These reports are often based on the OECD's standard audit file for tax (SAF-T) or variations thereof.

That said, it is important to distinguish between providing SAF-T data to the tax authorities on demand (for example, during an audit) and mandatory periodic reporting. On-demand reporting does not facilitate the continuous control of transactional taxes. Instead, this form of reporting is designed to facilitate the audit process. Thus, this style of SAF-T reporting is not truly a form of e-compliance.

Near Real-Time Reporting

Near real-time describes e-compliance models in which invoice details are not reported upon issuance of the invoice to the buyer, but instead are communicated to the authorities a few days, or even weeks, later. Spain's Suministro Inmediato de Información (SII) is an example of this model. Under SII, transaction data must be reported within four business days of issuing an invoice. At least in theory, near real-time reporting for a business allows traditional manual checks of both invoice data quality and the VAT treatment of a transaction before the invoice is submitted to the tax authorities.

Real-Time Reporting

With real-time reporting, transactional data are reported to the tax authorities at exactly the same time the seller issues the invoice to the buyer. This communication channel is strictly one-way — seller to tax authorities. The real-time nature of this e-compliance model precludes any manual review of invoice data and the ability to check the accuracy of VAT treatment. This type of control must be automated and integrated into a company's enterprise resource planning system or billing application. Any and all corrections the taxpayer makes after issuing the invoice must be reported to the tax authorities.

Central Invoice Token

In this model, the seller must transmit invoice data to the government's system before sending an invoice to the customer. The central system generates a token that the seller must include in the invoice issued to the customer. The token certifies that an officially valid VAT invoice has been issued. If the customer is entitled to deduct the input VAT, the same token must be transmitted to the tax authorities so they can match the reported and deducted VAT.

Central Invoice Clearance

In this model, all invoice data must be transmitted to a central tax administration platform, and the platform sends the invoice to the customer. When that occurs, output VAT from the vendor and input VAT from the customer are automatically stored in the tax administration's platform.

The Pros and Cons of Pre-Filled Returns

Another key issue looms large in e-compliance, one that is both a pro and con: pre-filled returns. E-compliance provides the tax administration with all, or nearly all, of the transactional data it needs to pre-fill a company's periodic VAT return rather than relying on the company to provide the same data. This is both an advantage and a disadvantage.

On the plus side, pre-filled VAT returns are convenient and efficient.

On the negative side — at least from the business perspective — the situation enables tax administrations to question, in a highly targeted fashion, changes a company makes in its electronic report. The traditional method of running a VAT report from the company's ERP system will no longer suffice in response to these detailed inquiries. Instead, companies will need to perform gap-filling analyses and then investigate — and, when necessary, dispute — differences between the pre-filled data and the ERP VAT report.

Developments in E-Compliance

The need to reduce the VAT gap is widely considered the main driver behind e-compliance requirements. Yet a more detailed look suggests that another economic factor is also driving e-compliance adoption — high budget deficit levels. Budget deficits help explain why Spain introduced SII, why Bolivia and Uruguay introduced invoice clearance, and why France announced that it intends to implement an invoice clearance model. Budget deficit numbers may also explain why some countries — such as Bulgaria, Greece, and Lithuania, all of which saw a budget surplus in 2019[1] — are moving slowly, or not at all, toward e-compliance despite relatively high VAT gaps.

Among those countries that have introduced or announced an invoice clearance or near real-time reporting obligation, some member states — for example, Greece, Italy, and Poland — appear to be primarily driven by the desire to reduce their VAT gaps. Other countries — for example, France, Hungary, and Spain — appear to be more interested in leveraging new e-compliance requirements to address budget deficits. (See table.)

[1] Eurostat, "General Government Deficit (-) and Surplus (+) — Annual Data" (Apr. 22, 2020).

VAT and Budget Data for Select Countries

Country	VAT Gap %	2019 Budget Surplus/ GDP %	VAT * Deficit
Romania	35.88	-4.30	-154.28
Italy	25.90	-1.60	-41.44
France	11.92	-3.00	-35.76
Slovakia	25.68	-1.30	-33.38
Hungary	13.33	-2.10	-27.99
U.K.	11.67	-2.10	-24.51
Belgium	9.68	-1.90	-18.39
Poland	20.80	-0.70	-14.56
Spain	2.71	-2.80	-7.59
Lithuania	24.52	0.30	7.36
Bulgaria	13.56	2.10	28.48
Greece	29.22	1.40	40.91
EU average	**13.68**	**-0.29**	

Given the relative size of their VAT gaps and budget deficits, it is surprising that Romania and Slovakia have not implemented e-compliance; the same holds for Belgium, with its above-average budget deficit.

It will be important to monitor the rollout of e-compliance in Europe in the coming years. Because of the COVID-19 pandemic, the European Economic Forecast predicts that budget deficits as a percentage of GDP will significantly increase in 2020 and 2021 thanks to increased expenditures and stalling revenue. In the model illustrated in Figure 1 and based on the spring 2020 European Economic Forecast, 2021 looks slightly better than 2020, but that improvement hinges on the nature of the economic recovery.

The EU faces pressing questions about how member states will finance their increased deficits. It is politically and economically challenging to increase taxes on labor, especially with high levels of unemployment, or corporations, especially because they are the drivers of the economy and already under economic stress. Therefore, countries are likely to turn to environmental taxes and VAT, with VAT being the larger source of revenue. However, increasing VAT rates is less appealing economically because doing so is likely to reduce overall consumption. Broadening the tax base for VAT by eliminating reduced rates and exemptions has also proven to be politically challenging.

In contrast, focusing on fighting fraud, decreasing the VAT gap, and increasing compliance levels will generate few objections, especially in the political arena. This agenda could pave the way for a wider acceptance of e-compliance. Not surprisingly, the Billentis report — from a provider of invoicing services aimed at companies that are considering the use of e-invoicing for, *inter alia*, billing, compliance, and invoice management — predicts that real-time clearance models will become the dominant method worldwide by 2025.[2]

Figures 2, 3, and 4 show the impact of increasing budget deficits on the adoption of CTC requirements in the EU. Based on 2020 data, it appears that almost all EU countries can be expected to introduce some form of e-compliance requirement.

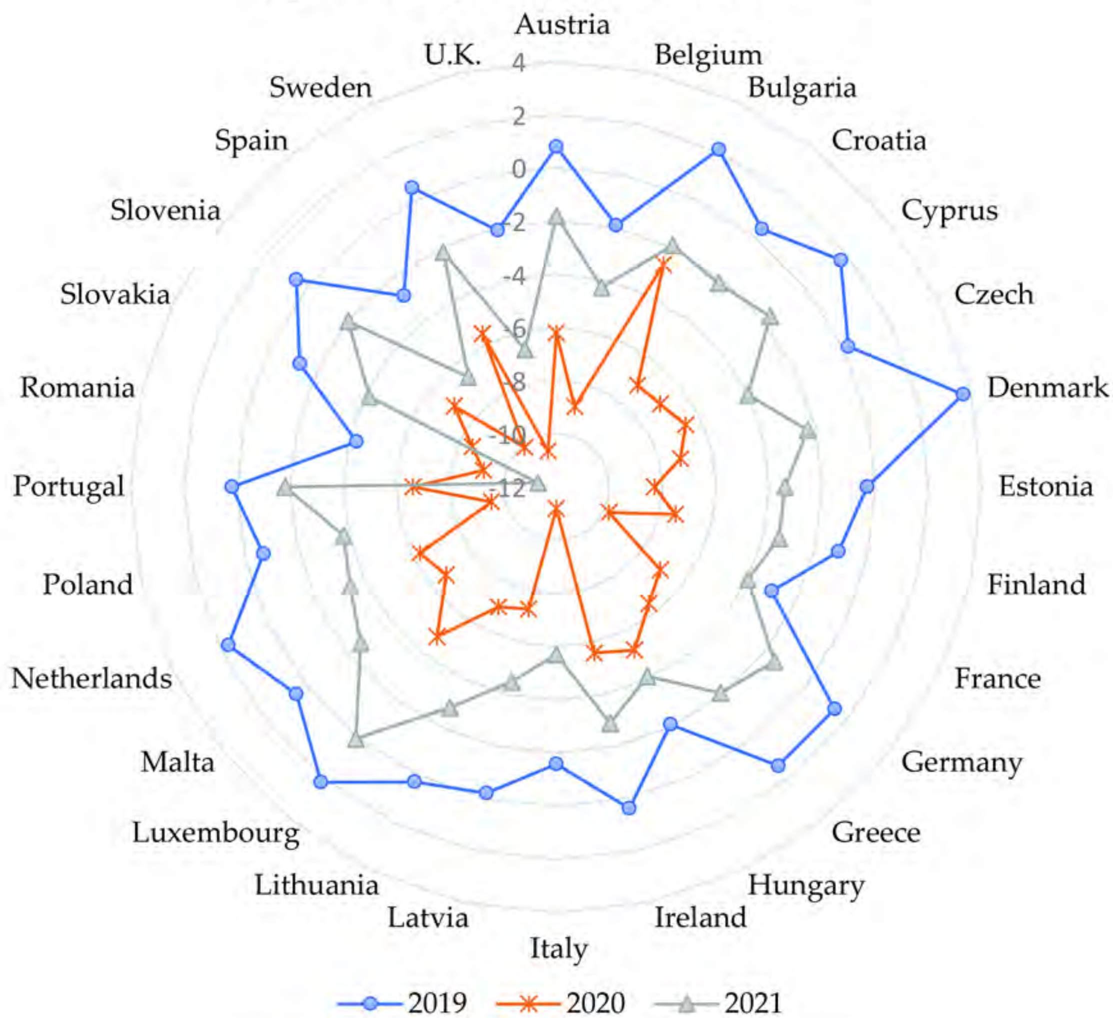
Five Key Compliance Challenges

Several aspects of the existing e-compliance rules have proven challenging to companies, including the lack of a standard approach EU-wide, timing issues, and language barriers. The fact that these mandates differ by country presents a formidable challenge, especially for multinational companies. If several countries decide to pursue e-compliance simultaneously, the following challenges would multiply and the impact on companies and their tax departments would be significant.

Further, country-specific e-compliance requirements often undergo several rounds of changes after the initial enactment. Every version requires companies to design and implement changes to their compliance systems. And changes often mean contending with the same timing and language challenges (discussed in the following subsections) that accompanied the rules' initial implementation.

[2] Bruno Koch, "The E-Invoicing Journey 2019-2025," Billentis (Sept. 2019).

Figure 1. Budget Deficit or Surplus/GDP %



Timing

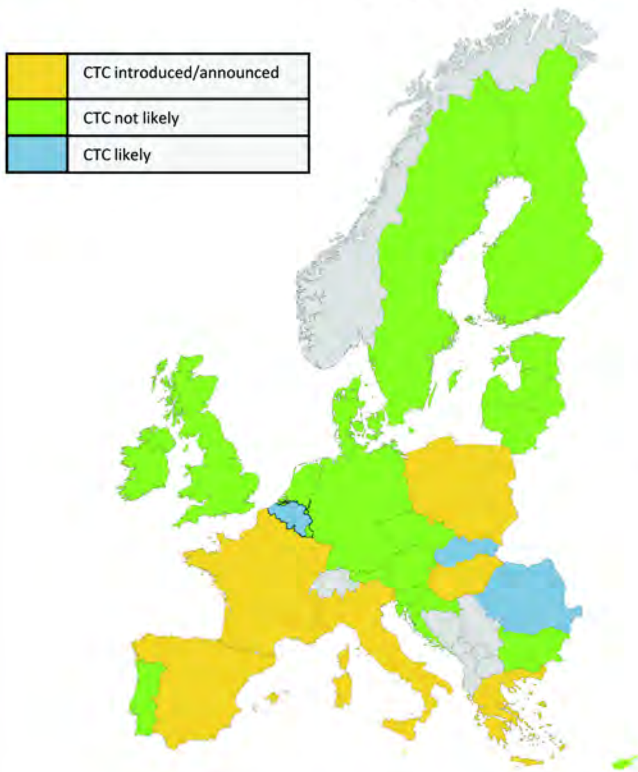
A country's initial announcement that it will introduce a form of CTC typically occurs well in advance of the date that the new requirements take effect. Still, working through the technical details requires substantial time, and that process cannot begin until the new rules are finalized and made public. Only then can companies and their tax groups begin impact assessments, implementations, and testing processes — activities that often require several months to complete. Likewise, ERP vendors and other software providers must wait until a new e-compliance rule has been finalized before adjusting their existing offerings and developing new solutions. For these reasons, it is noteworthy that e-compliance rules can be implemented rather quickly, which Italy demonstrated when it completed the legal process necessary to obtain the required derogation from the EU VAT directive in about six months.

Communications

The language used to introduce a new e-compliance rule can also place stress on an organization, especially a multinational entity. If the only document that a country offers in English is a high-level summary of the law and the detailed technical requirements are only available in the local language, IT and tax professionals may need to rely on third-party translations.

During the implementation and testing phases, both IT and tax personnel may need support from an official help desk. If the help desk

Figure 2. 2019 Data on CTC Adoption



Country	VAT * Deficit	Rules Introduced
Romania	-154.28	
Italy	-41.44	2019
France	-35.76	2023
Slovakia	-33.38	
Hungary	-27.99	2018
Belgium	-18.39	

Note: Based on EU 2019 data.

communicates only in the local language, it creates a hurdle for communication for non-domestic professionals.

Information Systems

The key question for system development is: What needs to be done to provide the authorities with all mandatory data in the proper format? Answering this question requires an in-depth assessment of the required data and how the company can collect the data from its systems. This requires meticulous testing and reconciliation to ensure that all data are consistent, correct, and complete. The next step is to assess whether the company has systems in place that can securely transmit the data in the proper format to the tax authorities. Again, ensuring the authenticity and integrity of the data is critical.

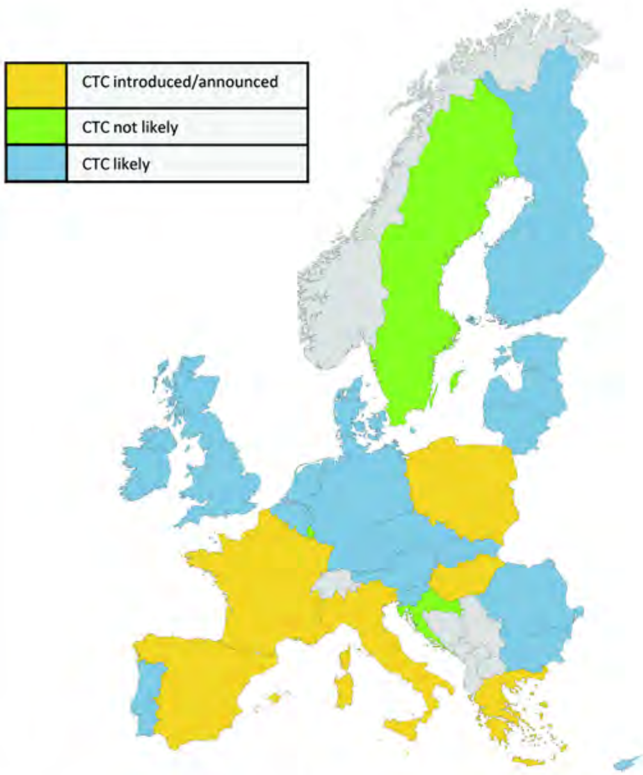
Process Changes

From a business perspective, CTC requirements are part of regulatory financial reporting and, therefore, they affect finance and VAT processes and responsibilities. The additional reporting activities need to be assigned and integrated into work processes. Reconciliation of CTC data with other VAT reports needs to be executed, any differences need to be resolved, and review and signoff responsibilities must be assigned. If a third-party service provider performs any of these activities, it may require the renegotiation of the existing terms and conditions of services and an expanded service agreement.

Related VAT Compliance Uncertainty

CTC and e-compliance rules are not the only important development involving VAT in the EU. Business and tax leaders should expect regulators to gradually require more VAT data to be combined with financial and logistics data. For

Figure 3. 2020 Data on CTC Adoption



Country	2020 VAT * Deficit	Rules Introduced
Romania	-330.10	
Italy	-290.08	2019
Slovakia	-218.28	
Poland	-197.60	2021
Greece	-187.01	2020
Lithuania	-171.64	
U.K.	-123.70	
France	-116.82	2023
Czech Republic	-93.65	
Belgium	-86.15	
Latvia	-82.27	
Hungary	-69.32	2018
Portugal	-67.06	
Germany	-65.73	
Ireland	-62.44	
Denmark	-61.27	
Finland	-59.05	
Slovenia	-57.08	
Estonia	-56.27	
Austria	-45.26	
Bulgaria	-36.61	
Cyprus	-33.11	
Spain	-27.37	2017
Netherlands	-25.20	
Malta	-18.16	

Note: Based on EU 2019 data.

example, the EU's proposed directive regarding payment service providers (COM(2018) 812 final) should take effect in 2024. The proposal would obligate the providers to collect, transmit, and retain specific data on payees and payment transactions (information that will need to be made available to national authorities). The EU is also working on a proposal to collect and exchange electronic freight transport information (COM(2018) 279 final), which is expected to take effect by 2025.[3] Also, some countries outside the EU (for example, Brazil and India) have implemented systems that combine the bill of lading with digital or centrally approved invoices.

Unfortunately for businesses, the horizon is far from clear. The developments are likely to proceed in a step-by-step fashion, leading to a complicated patchwork of requirements and solutions.

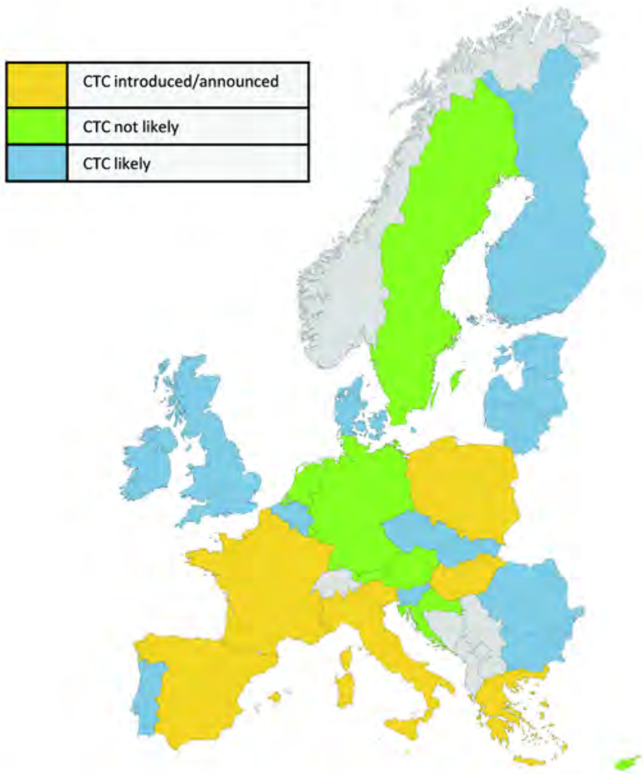
[3] International Road Transport Union, "Milestone for Road Transport Companies to Digitalise Further Within Reach" (May 4, 2020).

Conclusions: Big Impact, Little Time

The explosive growth of country budget deficits because of the COVID-19 crisis makes the broader adoption of e-compliance highly likely. Despite the challenges these new requirements may pose, they could ultimately benefit companies by significantly reducing the overall VAT compliance burden. Also, it seems likely that blockchain and other advanced technologies will be deployed across the value chain in ways that facilitate the integration of financial, logistical, and VAT data.

However, reaching a utopia in which VAT compliance is fully automated will require time — years, to be sure, devoted to addressing and resolving substantial compliance pain. Companies must invest considerable time and money to make the process improvements and systems adjustments needed to satisfy new CTC requirements. The lessons learned from recent e-compliance efforts suggest that companies will need at least six to 12 months to properly

Figure 4. 2021 Projections for CTC Adoption



Country	2021 VAT * Deficit
Romania	-405.44
Italy	-147.63
Slovakia	-107.86
Poland	-79.04
U.K.	-78.19
Lithuania	-68.66
Greece	-61.36
Czech Republic	-56.76
Hungary	-54.65
Latvia	-50.72
France	-47.68
Belgium	-41.62
Ireland	-32.34
Finland	-27.13
Bulgaria	-25.76
Estonia	-23.05
Denmark	-19.57
Portugal	-18.29
Spain	-18.16
Slovenia	-16.08

Note: Based on EU 2019 data.

implement and test forthcoming CTC systems. The precise amount of time and effort needed will depend on the complexity of the new rules, the availability of resources, the complexity of the business structure, and the number of systems and legal entities that are affected by the rules.

These substantial e-compliance challenges create both a need and, importantly, an opportunity. The European Commission should develop a standard set of requirements that can be deployed across the EU and a consistent roadmap to guide companies and tax authorities through the implementation of the rules. This window of opportunity is brief — several EU member states have begun adopting new e-compliance requirements unilaterally. As more member states adopt their own rules, the likelihood that a common EU standard can be developed decreases — and that means a substantially higher compliance burden for companies and tax departments. ■