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Extension of French Reverse Charge Mechanism

Over the last few years, there has been a marked upturn in the level of European Union (EU) VAT fraud, with material tax losses estimated at some 15% of net tax revenues. Several Member States have recently taken steps to combat this growing problem, with varying degrees of success, by attempting to introduce the reverse charge mechanism. The French government has recently introduced that mechanism in respect of supplies made by non-resident suppliers. In this article, the author describes the effects of that mechanism.

1. Introduction

Over the last few years, there has been a marked upturn in the level of (EU) VAT fraud, with material tax losses estimated at some 15% of net tax revenues. Every day there are reports in the news of VAT fraud that is estimated to cost the EU Member States some EUR 62 billion annually. Several Member States have recently taken steps to combat this growing problem, with varying degrees of success, by attempting to introduce the reverse charge mechanism.[1] Under that mechanism, the liability to account for VAT shifts to the customer in certain circumstances, thus removing the opportunity for fraudulent suppliers to charge and collect VAT without paying it over to the authorities. The French government has recently introduced similar provisions, albeit only in respect of supplies made by non-resident suppliers. Although France is by no means the first Member State to extend the reverse charge mechanism to supplies made by non-resident businesses,[2] these changes are timely in that they highlight some of the practical issues that can arise when such provisions are introduced. With the reverse charge mechanism seen as the panacea to the growing problem of EU VAT fraud, we will examine the new French rules in more detail and look at some of the consequences for businesses affected by the newly introduced arrangements.

2. The Old Rules

In order to appreciate the extent to which the rules have changed in France, it is helpful to have a basic understanding of the old rules, i.e. the rules that were in force up until 31 August 2006. Under the old rules, non-resident ("foreign") businesses that made supplies of goods or services, which were taxable in France, were generally required to register there for VAT purposes and file periodic VAT returns.

Example

A US company with no local presence in France purchases goods from a French registered supplier. The US company then supplies those goods to a French registered customer. The goods remain in France.

Under the old rules, in respect of the subsequent supply, the US company would have been required to charge French VAT to its French customer, and to collect and account for that VAT to the French government by filing periodic VAT returns. Consequently, the US company would have been required to register for VAT in France. Its VAT returns would have indicated the amount of VAT due to the French government, against which the US company would have been entitled to offset any VAT that it had incurred on local purchases and expenses, including the purchase of the goods from the French supplier. Depending on the amounts involved, this would usually have resulted in a net payment being due to the French government. This payment would have had to be made by the same deadline that applied to the filing of the VAT return.

Consequently, in many respects, the US company would have been treated in exactly the same way as businesses established in France. Although it is not established in the European Union, the US company would have been unable to make use of the VAT refund scheme for non-EU businesses under the procedure laid down by the so-called Thirteenth Directive, as it was conducting taxable supplies in France for which it was liable to account for the VAT that was due. Under the old rules, therefore, the only way in which the US company could recover the VAT it incurred was via its French VAT returns.

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1. For example, the UK plans to extend the reverse charge mechanism as soon as possible to supplies of electrical and electronic goods made by businesses resident in the United Kingdom; see *International VAT Monitor* 5 (2006), p. 395, and 6 (2006), p. 482, and this issue, under *VAT around the World*. Attempts of Germany and Austria to obtain authorization to extend the reverse charge mechanism to supplies made by resident businesses have been temporarily blocked by the European Commission; see *International VAT Monitor* 5 (2006), p. 377. Under Art. 21(2)(c) of the Sixth Directive (Art. 199 of Directive 2006/112), Member States are entitled to introduce the reverse charge mechanism in respect of supplies in the construction and waste materials sectors and to other designated supplies made under specific circumstances. Finally, several Member States have been authorized by the Council to apply the reverse charge mechanism in sectors vitiated by large-scale missing-trader fraud, for example, in the Netherlands, in the clothing sector.
2. As regards supplies of goods and services made by non-resident businesses, the Netherlands has applied a general reverse charge mechanism from the date of introduction of VAT, in 1969, and also other Member States, such as Austria, Belgium, Cyprus, the Czech Republic, Germany, Estonia, Finland, Italy, Sweden and Slovakia apply that mechanism to all or large categories of supplies made by non-resident suppliers.

3. The New Rules

By contrast, under the new rules that were brought into force on 1 September 2006, foreign businesses making supplies of goods or services, which are taxable in France, to businesses that are registered for VAT there, must no longer charge and collect VAT on these transactions. Instead, the customer is liable to account for VAT on the value of the received goods or services under the reverse charge mechanism. If we apply the new rules to the previous example, the result is that, even if it was registered in France under the old rules, the US company must no longer charge, collect and account for the French VAT that is due on the supply of the goods or services to its French registered customer. Instead, the French registered customer must account for the VAT due through its periodic VAT return. On the assumption that it is not engaged in any other category of activities in France, the US company will no longer be required to be registered in France and file French VAT returns or, rather, the US company will be required to deregister in France. Deregistration implies that the US company will only be entitled to recover any French VAT incurred in the framework of its activities and transactions in France through the Thirteenth Directive refund procedure. This is a significant change since there are very different conditions and deadlines that apply to making Thirteenth Directive refund claims and these are generally very strictly enforced throughout the European Union. Hence, there is a risk that the US company could lose its entitlement to recover the VAT that it has incurred, if it fails to realize that it should deregister under the new rules and use the Thirteenth Directive refund procedure as opposed to filing VAT returns.

3.1. Activities that are taxable in France

The above situation is a very straightforward example to illustrate the basic difference between the old and new rules in buying and selling goods in France. Other transactions that are within the scope of French VAT include:
- the importation of goods into France from outside of the European Union and subsequent onward supply;
- the intra-Community acquisition of goods in France from another EU Member State;
- assembly and installation in France of supplied goods;
- organization of conferences, exhibitions and other similar events, physically taking place in France, etc.

These are just some of the transactions that are deemed to be within the scope of French VAT, regardless of the status and location of the supplier, and there are many others. Foreign businesses supplying such goods or services will be affected by the new rules in terms of their French VAT registration and compliance obligations, as well as their ability to reclaim French VAT on local purchases and expenses.

3.2. Status of customers

Application of the new rules largely depends on whether or not the foreign business's customers are registered for French VAT.

If at least one of its French customers is not registered for French VAT, the foreign business will need to remain registered in order to charge, collect and account for the VAT that is due on the supplies that it makes to the non-registered customer or customers. This is because its non-registered customers will be unable to account for the VAT that is due on the supplies received from the foreign business. The fact that the foreign business remains registered in France does not affect its VAT liability in respect of supplies made to French registered customers. The latter supplies must be invoiced without French VAT, as the liability to account for VAT on those supplies will be with the customers. As a result, any foreign business that has some customers that are registered for French VAT and others that are not will need to adopt different VAT invoicing and accounting procedures depending on the status of each customer. The foreign business will still be required to file periodic VAT returns in France, and any French VAT that it incurs on local purchases and expenses is recoverable via those returns, subject to the normal rules.

If all of the foreign business's customers are registered for French VAT, then it will most likely be required to deregister and to recover any VAT that it incurs via the Eighth or Thirteenth Directive refund procedure, as appropriate (the Eighth Directive refund procedure is for businesses that are established in another Member State, whereas the Thirteenth Directive refund procedure is for businesses that are established outside the European Union). This is because the liability to account for VAT will be shifted to the French VAT-registered customers in all cases. (It should be noted here that the customer could also be a non-established business, e.g. a German company – what is relevant is that it is registered for French VAT).

However, even though all of their French customers are registered for VAT in France, the foreign businesses may still need to remain registered there.

3.3. Intra-Community transactions

The group of foreign businesses that must remain registered in France despite the fact that all of their customers are also registered there, concerns those businesses that transfer goods to France from another EU Member State for the purpose of making onward domestic supplies to the French customers. These foreign businesses may need to remain registered in order to report the transfer of their own goods for Intrastat[3] purposes. Despite remaining registered for French VAT, such businesses should not be required to file VAT returns however, as

3. Intrastat is the name given to the EU-wide statistical declarations that monitor cross-border trade in goods between EU Member States.

the liability to account for VAT on the onward domestic supply of the goods rests with the French registered customers (there is also no obligation for the foreign business to account for VAT on the intra-Community acquisition of the goods in France because, under those circumstances, the acquisition is exempt from VAT[4]). That being the case, any French VAT that the foreign business incurs on local purchases and expenses should be recoverable via either the Eighth or Thirteenth Directive refund mechanism, as appropriate.

This of course assumes that all of the foreign business's customers are registered for French VAT, that the goods remain in France and that it does not have any other activities that are subject to French VAT. If, for example, the foreign business were to make a supply to a customer that was not registered for French VAT, or to dispatch goods from its French stock to another EU Member State (e.g. to fulfil an urgent order), then this may trigger the need to submit a VAT return for the period in question in order to report the domestic or intra-Community supplies.

4. Practical Issues

The circumstance that a VAT return must be submitted for a specific tax period, gives rise to the practical question of whether input VAT incurred in that period should be included on that VAT return or reclaimed via the Eighth or Thirteenth Directive refund procedure. Indeed, the new rules give rise to many such practical issues.

Other practical issues that arise include how the foreign business should go about identifying the French VAT registration status of its customers and then ensuring that it is kept informed of any changes. This is particularly important as any change in the French VAT registration status of its customers may have an impact on the French VAT registration status of the foreign business itself.

For foreign businesses that are required to deregister under the new rules, e.g. on account of only supplying taxable goods or services to French VAT-registered customers, the question of when to deregister arises. In theory, the answer is "immediately", once there is no longer an obligation to remain registered; however, the French authorities have indicated that they will take a "light touch" approach at least until the end of 2006. Some foreign businesses may therefore wish to take advantage of this lenient approach and to remain registered for a little longer to order to adapt their systems and procedures to the new rules.

Whenever the business eventually deregisters, however, there will always be the question of how to deal with VAT incurred prior to the effective date of deregistration. The answer to that question partly depends on what type of transaction the VAT relates to, as there are different rules for determining when VAT can be reclaimed on purchases of goods and services. For example, in respect of services, VAT can only be reclaimed in France when those services have been paid for. Therefore, VAT incurred on services that are paid for prior to deregistration should be recovered via the business's French VAT returns, subject to the normal rules, whereas VAT that is incurred on services that are paid for after deregistration should be recovered via the Eighth or Thirteenth Directive refund procedure, as appropriate.

In order to ensure that any Eighth or Thirteenth Directive claim is successful, the foreign business should ensure that its former French VAT registration number is not shown on any of the invoices that are to be submitted to the French tax authorities. If its number is shown, the foreign business should approach the French supplier to have the invoice credited and reissued without the number if at all possible.

5. Conclusion

Whilst the new French rules appear deceptively simple, foreign businesses must take into account various considerations, and many practical issues can arise in the course of their implementation. Foreign businesses that fail to implement the new rules correctly may incur a penalty; however, the greater risk is that they may inadvertently lose their right to recover any French VAT that they incur on related purchases and expenses. Careful planning is therefore essential.

4. Under Art. 28c(B)(c) of the Sixth Directive, intra-Community acquisitions of goods are exempt from VAT where the acquirer would in all circumstances be entitled to full refund of the acquisition VAT.