VAT changes to online sales: not just a tax concern

Unless you work in a company’s tax function, a value added tax (VAT) change that’s almost a year away is unlikely to keep you awake at night. But if that change means a 3.85% reduction in your annual net sales, or an opportunity to take a strategic look at your whole business, then maybe it’s time to think again.
VAT changes to online sales: not just a tax concern

Tax regulations are changing for the online sale of telecoms, broadcasting and digital content to private individuals who are resident in the European Union (EU). At present, VAT is paid in the country of the supplier. But from 1 January 2015, it will become payable in the country where the customer resides. Anyone selling digital products such as newspapers, music, software and games within the EU will be affected. Overnight, the VAT on content delivered from a supplier in, say, Luxembourg to a customer in Hungary will rise from 15% to 27%.

This change clearly has wide-ranging implications for the tax requirements of affected companies. But there are also much wider cross-functional business implications. EY has identified five key areas where the businesses affected are most likely to feel the impact of the 2015 VAT change. These are: taxation, pricing and channel to market, third parties, systems and customer experience.

A shift from one tax authority and one VAT rate to many

At present, many suppliers of digital goods in the EU consider basing themselves in countries such as Luxembourg, where they pay a flat rate of 15% VAT on all of those sales, regardless of the country in which they are sold. But from 1 January 2015, being based in Luxembourg will have absolutely no VAT benefit at all. Companies will be required to charge VAT and account for VAT in the country where their customer is based.
sells into Hungary, it will pay 27% VAT, the highest rate in the EU. Also, the different jurisdictions will have very different levels of aggression toward compliance and collection. For example, countries such as Greece and Italy, which still have some way to go to repair their public finances, may take quite an aggressive view toward collecting what is, in effect, a brand new source of revenue that they could never have banked before.

In summary, the tax effect of the 1 January 2015 changes is a shift from dealing with a single tax authority with one registration, one filing, a single compliance burden and a predictable VAT liability, to dealing with many tax authorities with varying characteristics and fluctuations in VAT rates.

Taking the hit to margins or varying prices per country?
At present, a company selling digital movies across the EU probably sells at a single price in all Member States. Let’s say that it charges €5 per movie, regardless of where the consumer is located. If the company chooses to maintain this pricing policy after 1 January 2015, then any increase on VAT incurred by selling into a country with a different level of VAT from where the company is currently based is, in effect, a direct hit on its margin. Taking the example of Hungary, if today a company is selling to a consumer in Hungary but paying 15% VAT in Luxembourg, after the VAT changes, it will pay 27% VAT in Hungary. Should the price remain the same, it will come directly out of its margin.

Companies will need to decide whether they are prepared either to take a margin hit or to vary their pricing. If they choose not to take the hit, then they must ask themselves a series of questions: how do we change our pricing? Do we increase prices for everyone and still have a single price? Do we start to charge different prices in different countries? If we change prices, what is the impact on our margin? How elastic is the price of the goods that we’re selling?

There is also an important market consideration. If the company has to pay 27% VAT on each sale in Hungary, then they need to ask themselves whether they have enough customers in that market to make it viable to operate there. They may decide that it is better to shut down operations in that market and divert resources to finding new customers in a country that charges less VAT.

EY has produced a case study based on a fictitious company. This company provides digital content to customers based in France, Germany, Hungary, Italy, Luxembourg, Spain and the UK. It is headquartered in Luxembourg, where the company takes advantage of the favorable tax and VAT regime. Customers are able to stream movies at a cost of €5 (VAT inclusive) per movie. In 2012, the company sold 10 million films to customers across its seven target countries, France, Germany and the UK each provides 20% of the company’s sales, Hungary, Italy, Luxembourg and Spain each provides...
VAT changes to online sales: not just a tax concern

10%. Based on these percentages and the existing VAT rates in these countries, should the company choose not to change their pricing, the impact of the 2015 changes would represent a €1.7m reduction, or 3.85% fall, in net yearly sales.

Although the changes come into force on 1 January 2015, the clock is already ticking. Anyone selling, for example, a 12- or 18-month subscription to an online movie service is already in the danger zone. The portion of the subscription that falls after the changes come into force will attract the new VAT level. Those who have already sold subscriptions that stretch beyond 1 January 2015 are, in effect, already accepting the hit on their margin – because they cannot go back and change the contracts. So, companies need to think about their pricing immediately.

Dealing with third parties: legal, commercial and practical issues

A lot of businesses sell digital products through third parties, such as Apple or Google. Businesses that provide these services need to ensure that all parties within their supply chain clearly understand where responsibility lies for accounting for VAT as of 1 January 2015.

Businesses need to consider the legal, commercial and practical issues relating to their supply chain. For example, from a legal perspective, contracts will need to support the correct VAT reporting position, and VAT legislation regarding intermediary supplies will need to be considered as part of this review. From a commercial perspective,
all parties within the supply chain should understand the commercial impact of VAT reporting in all EU countries. VAT increases could decrease the margin achieved on sales to the consumer, and thereby have a knock-on effect on the commission that other parties in the supply chain will receive. From a practical perspective, information about the customer will have to be collected and stored by the entity responsible for accounting for VAT. This may not always be the entity that has a direct relationship with the consumer.

For businesses that use intermediaries to reach their customers, it would be prudent, where possible, to check contractual terms or initiate discussions with the consumer-facing entity within the supply chain, in order to clarify who will be responsible for accounting for VAT. Suppliers should be cognizant of special rules in the VAT legislation, determining when businesses will be deemed to be acting in their own name where services are supplied through a telecoms network, interface or portal (such as an app). If they do not seek clarity, some businesses risk being taken by surprise if they are unexpectedly held responsible for accounting for VAT on supplies to consumers. They may be subject to audits, assessments, penalties and interest if they have not correctly accounted for VAT.

Suppliers should also consider their commercial arrangements. Even where the supplier receives commission only – and has no direct relationship with the consumer – the business should ensure that the 2015 changes will not significantly affect the net income that it will receive.

The impact on a company’s systems is far-reaching and significant

Making the purchasing process simple for customers is an important way of gaining competitive advantage when selling goods digitally. Most providers have developed a “one-click” purchasing system.

However, should a company wish to charge different prices based on where the customer resides, it will have to provide two pieces of non-contradictory evidence of address to the tax authorities. So, if the customer is using a mobile phone to order, the provider could capture the SIM card and the country where it is registered. They could also use the billing address of a credit card or IP address if the order is made online.

From a systems point of view, every site or app through which a company sells has to identify where each customer is based, capture two pieces of evidence that prove residency and also show the correct price. Previously, some companies may have simply hard coded pricing into their website. However, a modern, flexible pricing engine will be required to deal with dynamic pricing. Storing proof of customers’ location in a manner that complies with EU data privacy rules requires a strong customer relationship management (CRM) system. Storing the location is not enough. Proof must also be stored in case the tax authority demands to see it.

Finally, there’s the back end, the finance aspect. The tax engine and enterprise resource planning (ERP) system must be capable of calculating and filing tax in all of the different Member States into which the company sells.

In summary, there is a top-to-bottom impact across the IT estate: the front-end user experience across the apps and ecommerce sites, the transactional pricing and ecommerce engines, the CRM systems that are storing customer master data and the back end finance and ERP systems.

A more complex customer experience may lead to consumer anger

As we have seen, companies attract and retain customers by making the purchasing process as simple as possible. But the impending VAT changes mean that this simplicity can expose companies to new risks.

If a company decides to vary its price to take into account the different VAT rates
VAT changes to online sales: not just a tax concern

applied to its products, then customers may try to cheat the system. For example, a consumer in a high-VAT country such as Hungary may try to use virtual private network (VPN) software to mask their actual location and pretend that they are based in a lower-VAT country, where the price they pay will be lower.

The company is responsible for applying the correct amount of VAT. To avoid punitive measures from a tax authority, the company will need to introduce steps that demand proof. But these steps will interrupt the simple purchasing experience that the company has tried to create: they could require customers, for example, to register their bank details and provide proof of address. The result is that the purchasing experience will become less straightforward for the customer.

Remember, customers are not tax experts. When they are used to paying just €5 to download a film, many will be confused, even angry, when they are

Social media is an expanding repository for consumer anger. So, companies that choose to alter their prices should expect a backlash on social networking sites.
asked to pay €5 plus 23% VAT. And they may not understand why their friend across the border is paying €5 plus 17% VAT. Customer services should prepare to receive additional calls from customers querying and complaining about price rises. Social media is an expanding repository for consumer anger. So, companies that choose to alter their prices should expect a backlash on social networking sites.

One way of reducing the negative impact from a price increase is to prepare consumers for it. Companies should consider how to communicate to their customers that a VAT-driven price increase is coming, that prices will vary across EU Member States, and that customers will have to provide information proving where they live.

Adding value to your business

It’s clear that the impact of these VAT changes reach much further afield than a company’s tax function. And by looking at the wider implications, another important insight becomes clear. Preparing for the VAT changes is not just a piece of compliance. It is an opportunity for the providers of digital services to improve their pricing strategy, re-evaluate the markets in which they operate, work better with third parties, upgrade their systems and re-engage with their customers. In short, it is an opportunity to recalibrate their whole business. And if they take this opportunity, come 2015, they can ensure that a new year’s resolution to carve out competitive advantage is fulfilled on day one.

Every site or app through which a company sells has to identify where each customer is based, capture two pieces of evidence that prove residency and show the correct price.