B2C in Europe Through Madeira: Planning for the Near Future

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On 7 May 2002, the EU Council passed Directive 2002/38/EC and Regulation (EC) 792/2002, which require non-EU vendors to collect VAT on electronically supplied services purchased by nonbusiness EU residents.

The scope of the directive, which takes effect 1 July 2003, covers digital products such as software, computer games, data, publications, music, videos, and fee-based broadcasting services. In early April, the European Commission issued nonbinding guidelines on how to interpret the e-commerce VAT. The guidelines, issued during the first week of April, are based on the work of the United Kingdom's VAT Forum. (For related coverage, see *Tax Notes Int'l*, 14 Apr. 2003, p. 114, *2003 WTD 66-1*, or *Doc 2003-8739 (3 original pages)*.)

The Portuguese government is preparing implementing legislation, which will be released soon. An overview of planning opportunities that consider the use of a Madeira vehicle is presented below.

Non-EU vendors that make electronic sales within the European Union will be required to register for VAT either in every member state where its nonbusiness customers reside or in a single member state, under a special scheme, and to charge VAT at the rate that applies in the member state where their customers reside. The new e-commerce VAT regime will be on trial for three years, after which it may be changed or maintained.

A non-EU vendor, however, may avoid the uncertainty and complexity of the VAT compliance regime established by the directive by setting up either a subsidiary or a branch within a member state. The non-EU vendor is thereby subject to a similar VAT treatment than its EU counterparts, which charge VAT on sales to EU nonbusiness customers on an origin basis — that is, at the rate applicable in the registration state.

Madeira Island, an autonomous region of Portugal, with a well-run international business center (IBC) and the lowest VAT rate in the European Union (13 percent), therefore presents itself as the jurisdiction of choice for non-EU vendors to establish a subsidiary or branch and thus benefit from VAT treatment similar to its EU-based counterparts registered for VAT. (For prior coverage, see *Tax Notes Int'l*, 6 Jan. 2003, p. 10, *2002 WTD 246-8*, or *Doc 2002-27804 (2 original pages)*.)

Moreover, because VAT rates vary within the European Union between Sweden's 25 percent and Madeira's 13 percent, non-EU vendors may arbitrage across different tax rates and gain a fiscal benefit of up to 13 percent if registered for VAT through a subsidiary or branch in Madeira.

Non-EU vendors may use their fiscal competitiveness to present their services at a lower price and at a single price to all of their EU customers, rather than having to adjust the price of their products in conformity with the applicable VAT rate.

The EU Council's approval of Directive 2002/38/EC aims to create a level playing field between EU and non-EU vendors of digital e-commerce, based on the view that existing VAT rules give a competitive advantage to non-EU vendors.

Under the current VAT regime, the rule of article 9(1) of the VAT Sixth Directive determining the taxable place is applied to digital products, which are deemed to be supplied in the country where the supplier is sited, independent of the place of consumption.

European suppliers involved in business-to-consumer (B2C) transactions therefore must charge and account for VAT at their domestic rate on both their supplies to EU countries and to non-EU countries. On the other hand, services originating from a source outside of the European

[1]Under the current regime, no obligations are imposed on non-EU suppliers in the case of business-to-business sales because VAT is paid by the importing companies under a self-assessment mechanism — the so-called reverse charge mechanism. This aspect of the business-to-business sales regime will remain unchanged under the new E-Commerce VAT Directive.

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Union, namely a U.S. source, are not subject to VAT even when delivered within the European Union.[1] Considering that the VAT rate can reach up to 25 percent, EU suppliers are at a blatant disadvantage when competing with non-EU suppliers.

Furthermore, the OECD Committee on Fiscal Affairs has sustained and called for the collection of consumption taxes on cross-border trade "in the jurisdiction where consumption takes place." The OECD consumption tax technical advisory group further added that VAT on electronically supplied purchases by nonbusiness customers should be payable in the country in which that customer "usually resides."

A serious practical issue that non-EU-vendors will face is the burden of verifying both their EU customer's tax status and residence.

In approving the E-Commerce VAT Directive, the EC Council drew upon both the arguments above and its experience with the fairly successful implementation of the EU Telecommunications VAT Directive (Directive 97/209/EC of 17 March 1997),[2] under which a non-EU vendor of telecommunication services to a nonbusiness customer in the European Union must register and collect VAT at the applicable rate in the EU member states where those services are "used and enjoyed."

Following the introduction of the EU Telecommunications VAT Directive, several EU telecommunication services providers have successfully relocated their services to Madeira to reduce their VAT liability, whereas non-EU providers have conducted a subsidiary or branch operation from Madeira to have access to similar VAT treatment as their EU-based counterparts and to benefit from Madeira's lower VAT rate.

The approval of the E-Commerce VAT Directive has been widely criticized and is said to generate discriminatory treatment, as well as market distortions, on the grounds that it discriminates against non-EU vendors and imposes high compliance burdens on non-EU vendors in comparison with their EU-based counterparts.

The EC has realized that the obligations imposed on non-EU vendors might breach its obligations under the WTO and has sought to avoid this claim by establishing a "special scheme." According to this special scheme, only non-EU vendors are required to register for VAT with a single member state and to charge VAT at the rate applicable in the member states where its nonbusiness customers reside.

However, setting up a subsidiary or branch in Madeira is far more advantageous than the registration for VAT under that special regime. Under the latter, the non-EU vendor is still required to apply all the different 15 VAT rates of member states in accordance with the residence of its EU customers.

Furthermore, a serious practical issue that non-EU-vendors will face is the burden of verifying both their EU customer's tax status and residence. The costs involved in such a verification procedure should not be minimized because possible tax audits may trigger requalification by the tax authorities of the VAT treatment of the electronically supplied services rendered and subsequent liability for VAT not properly collected.

All of these problems can be successfully avoided through the establishment of a subsidiary or branch in a member state, namely in Madeira, because it will receive a similar VAT treatment as its EU-based counterparts and charge VAT at a single rate, Madeira's 13 percent VAT rate.

Furthermore, although compliance costs are expected to be lower under the "special scheme," the scheme does not allow a direct VAT refund of VAT incurred by the vendor on its purchases; instead, the vendor must make a separate refund claim under the 13th VAT Directive. Once again, a non-EU vendor subsidiary or a branch established within the European Union will not be exposed to difficulty in claiming the refund.

Nonetheless, even if non-EU vendors do not opt to set up a subsidiary or branch in Madeira, it is still tax advantageous for them to register for VAT under the directive's "special scheme" in Madeira.

Where there are difficulties in ascertaining and verifying the customer's tax status and residence, in case of doubt, a non-EU vendor registered under the special scheme in Madeira should be able to apply the residual rule of article 9 (1) of the Sixth VAT Directive, thus applying the VAT rate of the member state where they are registered and thereby benefiting from Madeira's lower 13 percent VAT rate.

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[2]There is a potential overlap between the E-Commerce and Telecommunications VAT Directives with respect to some services, and it is unclear which set of rules take precedence. The criteria used for the distinctive qualification of such services is based on the assumption that where it essentially involves the transmission or transportation of electronic content, rather than the production of the content itself, it is designated as "telecommunications services."

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Non-EU vendors that decide to take advantage of the tax-planning opportunities available, namely by establishing a subsidiary or branch in Madeira, should consider the direct tax implications of such an operation.

Besides the lowest VAT rate in Europe, Madeira is also a well-run IBC that offers companies licensed to operate within its boundaries an exemption from corporate income tax.

Therefore, if a non-EU company decides to set up a subsidiary or branch in Madeira to supply B2C digital services, the income derived from those activities may be (provided requirements are met) exempt from income taxation — specifically withholding taxes.

For direct taxation purposes, one must examine the characterization of the income derived from the sale of digital services.

The various types of electronic commerce payments are characterized by the majority of tax experts as business profits, rather than as royalties or as payment for the provision of know-how.

As in any given transaction, the main question to be addressed is the identification of the consideration for payment. Payments related to the sale of a digital service are made to acquire data transmitted in the form of a digital sign for the private use or enjoyment of the buyer. This is the essential consideration for the payment. A payment, therefore, should not be classified as royalties, even if the service implies the copying of that digital signal insofar as is necessary for its use; copying is incidental and should be disregarded for classification purposes.

Concerning the possible characterization of the income as payment for the provision of know-how, as opposed to the provision of services, only a case-by-case analysis can determine a final characterization. The distinction between the two characterizations should be based on whether that which is provided qualifies as an asset that already exists and is transferred, or if it is something brought into existence under a particular contract.

Nevertheless, domestic taxation in the Madeira IBC of income characterized as "royalties," provision of know-how, or "business profits" should not be an issue because such income appears to be tax-exempt.

Business profits derived in the pursuance of activities foreseen in the license of entities of the Madeira IBC may be exempted from corporate taxation according to article 33, no. 1, clause h) of the STI (the Portuguese Statute of Fiscal Incentives, which contains the basic fiscal framework applicable to companies licensed to operate in the Madeira IBC). Concerning royalties and the provision of know-how, article 33 no. 5, clause a) of the STI establishes a tax exemption for such income, provided the payment is not made to a resident entity or to a permanent establishment of a nonresident entity.

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Finally, Portugal has added a proviso to article 12 of the OECD Model Convention, by which it reserves the right to tax as royalties income derived from software other than income from the total transfer of related rights.

Therefore, the possible characterization of the income as payment for the "use of, or the right to use, industrial, agriculture, commercial or scientific equipment" rather than business profits should be analysed when a customer acquires a single-use or limited-duration software.

Our understanding is that in such a case, the characterization as payment for the "use of, or the right to use, industrial, agriculture, commercial or scientific equipment" must also be disregarded for direct taxation purposes because digital products: cannot be considered "equipment"; their use cannot be qualified as "industrial, agricultural, commercial or scientific"; and the concept of "use or right to use" is inapplicable to a payment made definitively to acquire a property designed to have a short, useful life for which most the digital products are designed. Therefore, income derived from the sale of single-use software of limited duration should be characterized as business profits, which, as mentioned above, are tax-exempt for entities of the Madeira IBC. ✦

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