THE KOHLL SYNDROME IN VAT LAW? Some Remarks On The Reverse Charge System In The Taxation Of Cross-Border Services

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The *Kohll a*nd *Decker* Cases[2] - A Reminder

Few decisions of the European Court in the last few years have caused so many discussions as the judgements in the *Kohll* and *Decker* cases. The judgements dealt with the use of services and the acquisition of goods to be paid for in both cases by a member state's social security system. For nearly thirty years, regulation 71/1408/EEC had governed European social security law and the use of services and the acquisition of goods by a person benefiting from social security, in a member state other than that where the competent social security institution had its seat, was possible only if certain conditions were met. Normally, an approval was required.

The plaintiffs in both cases were persons insured and living in Luxembourg who had acted without the approval required by Luxembourg social security law. Those requirements seemed to be in full compliance with the regulation, however the European Court regarded them as incompatible with the freedom of movement of services and the freedom of movement of goods. Any objections regarding the protection of health were dismissed due to the harmonisation of educational and security standards. The judgements sent shock waves not only through political and social security circles but also perturbed lawyers specialising in social security law and even those specialising in EC law.

Technically, it was absolutely clear that the provisions of the EC treaty overruled any kind of secondary law. The surprise was due to the fact that the regulation

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2 *Kohll v Union des Caisses de Maladie* (C-158/96) [1998] I-ECR 131; *Decker v Caisse de Maladie des Employés Privés* (C-120/95) [1998] I-ECR 1831.

71/1408/EEC had for a long time been regarded as a pillar of the freedom of movement of workers, enabling social security institutions of very different types to develop their systems in compliance with this freedom. Furthermore, it was regarded as an early masterpiece of EC legislation, harmonising the complicated social security laws with regard to cross-border situations. More than any other secondary legislation the regulation was regarded as determining the actual state of the EC law and setting the framework for the treaty's freedoms within its scope. It was difficult to understand that the provisions of this cornerstone of EC law were to be treated like any other technical provisions hindering the free movement of goods and services, and judged accordingly.

It seems possible that a similar experience could result in VAT law following the *Kohll* and *Decker* decisions. VAT law is regulated very thoroughly in the VAT directives, especially in the Sixth Directive[3]. VAT can be regarded as a nearly fully harmonised field of taxation which includes the situations arising out of cross-border supplies of goods and services.

German VAT Legislation

Member states have in general implemented the VAT directives in a very satisfactory way. Germany in particular has implemented the directives with diligence – albeit creating provisions with different wording and conforming to a concept which Germany regarded as more logical than that of the directives.

Most German VAT cases were brought before the European Court due to the fact that the German wording seemed to result in a different meaning from that of the directives. The European Court in most cases brought into congruence EC law and the German implementation of that law by giving German law an interpretation based on EC law. In very few German cases was an infringement of EC law found.

German legislators were aware that VAT law as such was governed by EC law. This did not hinder German governments in coming to the conclusion that certain taxable sales escaped German taxation where cross-border situations existed, and that the EC VAT system as set out in the directives did not preclude tax evasion.
As for sales of goods it was eventually understood that these were taxed correctly as long as the EC rules with regard to intra-community sales and acquisitions were adhered to. Services seemed to escape taxation more often. German

3 77/388/EEC.

legislation tried to amend VAT law in order to enable the German authorities to gain a tighter control of supplies of services. Where disputes arose as to whether amendments were in compliance with EC law, these amendments were revoked.
After having conducted a review, Germany lately has introduced further amendments to its VAT law. These amendments have a special focus on avoiding any conflict with EC law. According to section 13 b UStG[4], German VAT on services and on the sale of certain goods which the seller has produced specially for the buyer, has to be paid by the recipient of the services or the buyer of the goods, in cases where the provider or the seller belongs abroad but the place of supply is or is deemed to be within Germany. This rule applies where the recipient is engaged in entrepreneurial activities, even if their activities are zero-rated or tax-free, or even if the services and goods are used for non-business activities, or if they are public bodies. Vis-à-vis the fiscal authorities the recipients are regarded as the VAT debtors.

The consequence is clear. Insofar as the services or the goods in question are used for purposes entitling the recipient to deduct VAT, the VAT paid under these rules may be reclaimed by way of the VAT deduction procedure. This regime is different from the normal regime under which VAT is due from the person providing services or supplying goods. German VAT law has, however, always made an exception for services provided or goods delivered by persons belonging abroad. In such cases, the recipient of the services or the buyer of the goods had to account for VAT, if the recipient or the buyer was an individual or a company with entrepreneurial activities or a public body.

There was one major exception to the above rule. According to section 51 para. 2 UStDV[5] no VAT had to be accounted for if the recipient was entitled to a VAT deduction. This was a practical solution avoiding unnecessary formalities of tax payment and tax recovery.

It had never been clear whether the German system as such was in conformity with EC law or not. The German Federal Tax Court came to the conclusion[6] that the person belonging abroad and providing the services or selling the goods was the original VAT debtor and the recipient was only under a secondary liability for the VAT debt. Article 21.1(a) of the Sixth Directive however states that VAT is due from the recipient or buyer and that the provider of the services or seller is only liable for tax under certain circumstances set out in article 21.3. This

4 Umsatzsteuergesetz (VAT Act).

5 Umsatzsteuer-Durchführungsverordnung (VAT regulation).

6 BFH RIW 1995, 256.

problem has never been brought before the European Court. It has no bearing on the German problem of conformity.

Problems for the Free Movement of Services

The previous German VAT regime made it very simple for the German business sector to make use of services provided by enterprises based abroad. When receiving services from abroad the recipient had simply to decide whether the services were used for purposes which gave rise to a VAT deduction. In this case, no further facts were of any interest - VAT need not be paid and was not to be deducted. Receiving services from abroad was therefore as easy as (or easier than) receiving services from a German provider.

This has changed with the new regime. A German taxable person who enters into a contractual relationship with a foreign provider of services or seller of the goods has to prepare for a formal VAT declaration. It has to examine which kind of services are to be provided and, in particular, which kind of goods are to be delivered. Then the VAT liability has to be established. The supplier has to prepare an invoice without VAT which states that the recipient is the VAT debtor. The recipient who is responsible for the tax payment has to examine whether the supplier's invoice correctly reflects the tax basis. Tax due and tax deductible have to be declared by the recipient.

The new regime creates a great deal of uncertainty. The recipient of services or the buyer of the goods has to make a detailed review of the other party's situation. Without a list of questions prepared by a tax advisor it is almost impossible to fulfil the legal demands.

It may be quite difficult to get the necessary information. Take as an example services delivered by international railway companies having their seat abroad and operating cross-border trains between Germany and other member states. Insofar as the transportation service takes place in Germany, any entrepreneur and any public institution buying tickets has to declare the amounts paid for VAT purposes. Of course the suppliers do not in practice prepare invoices and make statements as to the amount of VAT due in respect of services rendered in Germany.

It is inevitable that at least entrepreneurs based in Germany will now be cautious in engaging in business with foreign providers. In many cases they will refrain from entering into such a business relationship as business with a German provider or seller will prove to be less complicated and less risky.

Conformity with the Sixth VAT Directive – Conformity with the EC Treaty?

The effects of the new German regime have to be examined under EC law. The new regime is faithful to the wording of the Sixth Directive. Article 21 gives a member state the right to regard the recipient of services and the buyer of goods in cross-border situations as the VAT debtor (the so-called reverse charge system). Germany seems therefore to adhere to the rules of EC law.

On the other hand, legislation which makes using services from a foreign provider less attractive than using those from a national provider, and causes a potential client to refrain from entering into business with a provider of services having his seat in another member state, inhibits the free movement of services. This has been stated clearly by the European Court in the *Safir* case[7].

The new German regime's disadvantages for cross-border business become obvious especially when it is compared with the former regime, and this leads to the question of whether there is a standstill clause prohibiting such developments. There is no general standstill clause in the Sixth Directive although such a clause might prove useful when the development of the whole VAT system is under examination. Within the Sixth Directive standstill clauses can be found only for certain fields of application. The system of reverse charge laid down in article 21 is not subject to a standstill clause.

There is no general standstill clause regarding the free movement of services or the free movement of goods. This is not surprising as the freedoms in the EC treaty have to be regarded as absolute whereas a standstill provision grants a relative degree of protection.

The German case is not really a case for a standstill clause. German recipients of services and buyers of certain goods have now clearly become aware of the fact that entering into a business relationship with foreigners can be complicated and therefore may refrain from doing so. In other member states where, unlike in Germany, the conditions have never been more favourable to cross-border business relationships, potential clients may also refrain from entering into such business relationships.

So the solution lies in the answer to the question whether the reverse charge system is in conformity with the freedoms of movement of services and of goods or not. It has to be admitted that the system was intended to facilitate cross-border activities. It was advantageous for any service provider.

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7 *Safir v Skattemyndigheten i Dalarnas Län* (C-118/96) [1998] ECR I-1897 – Note: judgment was given on the same date as the *Kohll* and *Decker* judgements.

When starting to do business in a foreign market a supplier did not need to be informed about foreign tax rules but could rely on the recipient's knowledge of the law in his home country. This fact created an equilibrium between the advantage for the provider and the disadvantages for the recipient. Enabling a potential client to receive services from a foreign provider as easily as from a national provider would promote the free movement of services.

If EC legislation had to choose it was acceptable that the choice had been made in favour of the advantages of the provider. It seems questionable whether this reasoning holds good any longer.

VAT law has undergone thorough harmonisation. An enterprise entering another member state's market will have knowledge of that member state's VAT law as it should be identical to the enterprise's national VAT system. The advantages for the provider under these circumstances seem hardly important enough to outweigh the disadvantages for the recipient - which in the end will affect the provider by barring him from business. It is difficult to justify the reverse charge system. The disadvantages of entering into a business relationship with a foreign provider are not compatible with the freedom of movement of services. They have to be abolished.

There is little doubt that a principle like the reverse charge system which is embedded in the Sixth Directive (which directive is regarded as the main pillar of the harmonised VAT system) will not easily be overthrown.

It has to be pointed out that the creation of the internal market, which led to a complete change in the responsibilities of the seller and those of the buyer of goods, had to be brought about by EC legislation after a long period of discussion and preparation. It could take a similar procedure to amend the rules for cross-border services.

On the other hand the existence of the internal market reflects the state of EC VAT law. The treatment of services has fallen behind when compared to the VAT treatment of sales of goods. Under these circumstances, the reverse charge system can no longer claim special protection. It has to be examined with regard to the freedom of movement of services and has to be judged accordingly as any other technical provision. It should be regarded as a normal process that harmonisation of VAT law has brought about a change, and has transformed the reverse charge system from a principle of the VAT system into a simple technical provision, which is subject to examination and which may be abolished if the European Court comes to the conclusion that it hinders the free movement of services.