VAT changes that will impact Law Firms

"VAT Package" to be introduced on January 1, 2010 will impact Law Firms

In Brief

On January 1, 2010 law firms with offices in the EU which make taxable supplies of legal services to business customers in other EU countries will have new monthly VAT reporting obligations. Failure to comply with these monthly reporting obligations can result in severe penalties being imposed (as much as £500k per annum if you operate in all EU countries).

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The EU has announced a package of changes to the VAT rules which mean sweeping reforms to the rules for determining the application of VAT for businesses that supply or purchase services, as well as introducing new monthly VAT reporting obligations.

Some of the changes are due to take effect from January 1, 2010 and the main changes that will impact law firms that have establishments in the UK and other EU countries are:

- changes to the rules on the place of supply of services for most Business-to-Business transactions; and
- a requirement to complete a monthly EC Sales List for supplies of taxable services to which the reverse charge applies

Changes to the rules on Place of Supply of Services

For the majority of the legal services provided by law firms to their clients, there will be no change i.e. if the service relates to land, the place of supply will be where the land is located. For other 'general' legal advice, the current rules apply but there will be new monthly VAT reporting obligations.

The filing of monthly EC Sales Lists is likely to add significant additional compliance costs and burdens, especially for those that may be unfamiliar with having to report intra-EU transactions.

One area where the change could impact law firms is where they have different legal entities in other EU countries or a branch network or a mix of both. So for example if your Hungarian firm supplies direct to a UK client or a UK firm/branch, that supply must be shown on its Hungarian EC Sales List. Each EU entity will now be required to be report all of its supplies of services on a monthly EC Sales List including supplies to associate firms.

Also, from January 1, 2010 if the UK or EU entities receive management and/or administration services, e.g. from the US, the recipient will be obliged to account for local VAT under the reverse charge i.e. a change to the current rule.

New VAT reporting obligations – EC Sales Lists

Law Firms that operate in the UK/EU which makes supplies of services to business customers in other EU countries will be required to file monthly EC Sales Lists (in addition to their VAT returns). At the present time HMRC have indicated that they anticipate businesses using the same form that is used for reporting goods (VAT 101) and to require the following data:

- country code
- customer's VAT Registration Number
- total value of supplies in sterling
- an indicator will also be required to identify services

There are of course penalties for not submitting the EC Sales Lists on time and if you operate in a number of EU countries, the risk and scale of penalties increases since you will have monthly reporting obligations in each EU country from which you operate.

What should you do now?

Although these changes do not take affect until January 1, 2010, Law Firms need to take action now to ensure that they have sufficient time to consider whether their accounting systems will have to be amended and that any required changes do not lead to disruption or unforeseen costs.

PwC has already started this process to ensure that its systems are ready to capture the right data to meet its monthly reporting obligations from January 1, 2010. By addressing these issues now since January 1, 2010 is not that far away, Law Firms can ensure that they will have sufficient time to reconfigure their accounting systems and avoid penalties for non-compliance. It will also ensure that there is minimal disruption to their business and that they have an optimal operating structure.

New tax point rules for intra-Community services

In terms of the new tax point rules for intra-Community supplies of services in respect of which the customer is obliged to account for VAT under the reverse charge, the time of supply of such services will be the earlier of when the service is completed or when payment is made. For continuous supplies of services, the time of supply will be linked to the end of each billing or payment period, but where no invoice or other accounting document is issued nor payment made during the year, the time of supply will be the end of each calendar year. These changes will determine not only when VAT has to be accounted for under the reverse charge, but also when the transaction is to be included on an EC Sales List.

New UK VAT invoicing requirements

The UK introduced new invoicing requirements with effect from October 1, 2007, the aim of which is to ensure that UK VAT invoices are compliant with the EU Invoicing Directive.

HMRC stated that it was its intention to implement the changes with a "light touch" and not impose penalties for non-compliance. Nevertheless, compliance with these new requirements is mandatory, and HMRC is likely to take a firmer line now that the rules have settled into place.

The main change that is likely to have a large impact on international law firms is for those that operate a centralised billing system. It is now the requirement that UK VAT invoices must contain unique consecutive numbering rather than a "unique identifying number" (as previously).

Therefore, if the law firm's billing system operates in such a way that one sequence of invoice numbers is used for all invoices issued by its UK and other EU entities (or even globally), then the invoices issued would not meet the requirements of the new UK invoicing regime and as such, could be exposed to penalties in each EU country from which it operates.

As such an international law firm will need to maintain a separate sequence for all VAT invoices issued in respect of supplies made in each EU country in which it operates. Please note, the prescribed form of VAT invoices could differ in certain EU member states.

We can help by...

- Reviewing your accounting system to ensure that it will capture the right data to be declared on the EC Sales List.
- Manage the whole EC Sales List compliance process for you on a territory by territory basis using our PwC's Global Network.
- Help identify those services that will be affected by the new tax point rules for intra-community services on a territory by territory basis
- This should ensure that you are not caught by the new penalty regime.

New Penalty Regime

The present VAT penalty regime has often been criticised by both taxpayers and those in professional practice due to the fact that it does not distinguish between honest errors made by businesses and deliberate errors made by less scrupulous taxpayers.

In addition it did not deal with taxpayers in an even handed way, due to the perceived high degree of discretion available to HMRC officers to mitigate penalties or even ignore errors in certain circumstances. Taxpayers have also commented that having separate penalty regimes for different taxes is confusing and adds to the already creaking administrative burden imposed on them.

As such HMRC decided to introduce a new penalty regime, which it believes will address these criticisms, and is furthermore designed to encourage taxpayers to modify the type of behaviours that lead to the inaccuracies in the first place. The level of penalty chargeable has therefore been "stepped" and will be higher for deliberate errors than for careless errors.

The range of penalties under the new regime will be as follows:

	Max penalty	**Min penalty where taxpayer disclosed error "with prompting" by HMRC**	**Min penalty where taxpayer disclosed error "without prompting" by HMRC**
Deliberate errors where taxpayer has attempted to conceal error from HMRC	100%	50%	30%
Deliberate errors where taxpayer has not attempted to conceal error from HMRC	70%	35%	20%
Careless error	30%	15%	0%

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Reasonable Care

As the new penalties are considerably higher than the present VAT misdeclaration penalty (currently set at 15%) it would obviously be best to keep out of the penalty system altogether. To this end, HMRC has confirmed that inaccuracies which arise from genuine errors by persons who have taken "reasonable care" will not fall within the scope of the penalty regime at all

Whilst this seems to be a positive statement, taxpayers should be aware that HMRC has not defined a minimum standard of what it understand "reasonable care" to mean. They have, on the other hand, confirmed that a taxpayer's risk profile will be considered "in the round".

Therefore, taxpayers who make frequent errors, even if promptly and fully disclosed may be considered to be "careless" – This is obviously particularly worrying for taxpayers who operate complex VAT recovery procedures, as the scope for error, and as such the risk of being brought into the penalty regime, is magnified considerably.

Mitigation for Disclosure

Should a penalty be imposed, then HMRC has the authority to mitigate the level chargeable (potentially to zero in the case of "careless" errors). However, HMRC has indicated that any mitigation will depend on the quality of any information given, as well as the necessity to "prompt" the taxpayer to make a disclosure.

Furthermore, the definition of "prompted" seems to have shifted. Whereas previously, any disclosure made to HRMC that was unconnected with an impending VAT audit (or even often made immediately before a VAT audit!) would be treated as "unprompted". However, HMRC has indicated that it will be narrowing the scope of what is meant by "unprompted". For example, disclosures that are made in a relation to a matter that was highlighted for review on an HMRC audit plan may be considered to be prompted, even if the error was made after the plan was issued, and the disclosure was made before any visits have been agreed.

We can help by...

- Reviewing your VAT compliance policies and VAT accounting systems to ensure that you are not an easy target for a test case given the impending introduction of the VAT package on January 1, 2010.
- Despite being, at face value, a welcome move towards easing the burden on tax payers who try to meet their VAT accounting requirements, the new penalty regime seems to raise as many problems as it solves, and we are likely to see many interesting cases in the near future exploring different aspects of the new rules.

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PricewaterhouseCoopers' team of partnership tax specialists has extensive experience advising US Law Firm clients on both sides of the pond. If you would like more details concerning any of the issues discussed above, please contact Stanley Kolodziejczak at (646) 471-3160 or Gregg Sincoff at (646) 471-1335 in New York, or Stephen Coleclough at +44 (0) 20 7212 4911 or Keith Lawson at +44 (0) 20 7804 9064 in London.