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On January 1, 2009 a minor change in the Czech Republic VAT[1] became effective. A use and enjoyment standard was added to modify the sourcing of certain service transactions.[2] Traditional proxy-based rules, derived from Articles 43 and 56(1) of the Recast VAT Directive (RVD),[3] are set aside by this modification when the customer receiving the services has a permanent establishment (PE) in the Czech Republic. The modification is authorized by RVD 58. Like many Member States, when it was faced with the task of transposing the sourcing rules for intangible services from the Sixth Directive into Czech law, the Czech legislature decided to closely tracking the wording of the Sixth Directive.[4] As a result the impact of the Czech change can be seen in large measure by following the Directive itself.

The January 1, 2009 change is a limited adoption of RVD 58(b), and functions like a full force of attraction principle in direct taxation.[5] If caught by these rules, transactions that would have been sourced outside the EU (and not subject to Czech VAT) will be sourced within the Czech Republic (and attract the Czech VAT). In most cases a reverse charge will apply. The new rule, found at Article 10, paragraph 14 of the Czech VAT Act, simply states:

> Where the place of supply of a service is according to subsection 6, except for services exempt from tax, is set in a third country, and this service is provided to a person who is concurrently a payer, the home country shall be considered to be the place of supply if the service is actually used or consumed by this person in the home country.

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[1] Czech Value Added Tax Act of 235/2004. (Czech VAT legislation can be found at: *Zákon c. 235/2004 Sb. o dani z pridané hodnoty ve znení pozdejsích predpisu*).

[2] *See* Pavel Fekar & Daniela Vykysala, *Czech President Signs Amendment to VAT Act*, Tax Analysts WTD 177-8; Doc 2008-19099 (Sept. 11, 2008).

[3] On November 28, 2006, Directive 2006/112/EC on the common system of value added taxation (recasting the Fist and Sixth VAT Directives) was adopted, entering into force on January 1, 2007. The RVD replace the SIXTH DIRECTIVE (Directive 77/388/EEC of 17 May 1977.

[4] Czech VAT §§ 9(1) & 9(2) closely follows RVD 43; Czech VAT Act § 10(6) closely follows RVD 56(1). This contrasts with the UK VATA which achieves the same result as RVD 43 and RVD 56(1) in the UK VATA §§ 7(10) and 9(2), but it does in a manner that does not follow the structure of the Sixth Directive at all.

It is not mandatory that Member States implement the Sixth Directive in any particular manner. The European Communities Act 1972, § 2 does make Community law directly effective in the Member States. In the EU this duality is respected: (a) there is national freedom to legislate in any manner the Member State desires, and (b) there is also an obligation to give effect to Community law as it is written. The consequence of this duality is frequently works out in the court system. The rule is, wherever possible, national law is to be construed in such a way as to be compatible with the provisions of the Directive [*Marleasing SA v La Comercial Internacional de Alimentacion SA*, Case C-106/89 [1990] ECR I-4135]. Provisions of a directive that are sufficiently clear and precise, and which have not been implemented by a Member State, may give rise to directly effective rights. When this occurs the Member State cannot rely on provisions of its national law which are incompatible with those rights.

[5] KLAUS VOGEL, KLAUS VOGEL ON DOUBLE TAX CONVENTIONS 3rd ed. (1997) 402 at ¶10, 421 at ¶ 48-49. (discussing the various permutation of the force of attraction principle, - a "full" force of attraction whereby any income sourced to a jurisdiction is taxable by that jurisdiction if that enterprise has a PE in that country; a "restricted" force of attraction whereby only income of the same type or kind as the income earned by the PE of an enterprise in that jurisdiction is taxable; "no" force of attraction whereby only income earned by the PE is subject to tax by that jurisdiction).

The reference to "subsection 6" in this passage is to the transposition into Czech law of RVD 56(1). It states:

> When providing a service to a foreign person or to a taxable person which has a registered office or place of business in another Member State or a facility located outside the home country, the place of supply shall be the place where the person to which the service is provided has the registered office or place of business, or the place of supply shall be the place where the facility is located if the service is provided to this facility, in case of these services

This modification can be a trap for the unwary. As is the case any time new sourcing rules are adopted, this change can produce unintended double taxation or non-taxation. Nevertheless, the Czech Republic is not the only Member State to take advantage of RVD 58. Austria, Belgium, Denmark, Estonia, France, Italy, the Netherlands, Slovenia, and the UK have also derogated, but none have done so in exactly the same manner as the Czech Republic, a situation which leads to yet further complications.

BACKGROUND

Under the EU VAT services are sourced by proxy rules. Two provisions set out the main rules, RVD 43 and RVD 56(1). The main (and therefore fall-back) rule is in RVD 43. It deems all services to be supplied at the seller's location. It states:

> The place of supply of services shall be deemed to be the place where the supplier has established his business or has a fixed establishment from which the service is supplied, or, in the absence of such a place of business or fixed establishment, the place where he has his permanent address or usually resides.

RVD 56(1) is an exception to RVD 43. It applies to specific services, also called miscellaneous services or sometimes intangible services. It is commonly observed that the number of the services involved in this exception makes it seem like the exception has swallowed the main rule.[6] RVD 56(1) deems these services to be supplied at the buyer's location.

[6] Article 56 lists these services as:

(a) Transfers and assignments of copyrights, patents, licenses, trademarks and similar rights;
(b) Advertising services
(c) The services of consultants, engineers, consultancy bureaus, lawyers, accountants and other similar services, as well as data processing and the provision of information;
(d) Obligations to refrain from pursuing or exercising, in whole or in part, a business activity or a right referred to in this paragraph;
(e) Banking, financial and insurance transactions, including reinsurance, with the exception of the hire of safes;
(f) The supply of staff;
(g) The hire out of movable tangible property, with the exception of all means of transport;
(h) The provision of access to, an the transportation or transmission through, natural gas and electrical distribution systems and the provision of other services directly linked thereto;
(i) Telecommunication services;
(j) Radio and television broadcasting services;
(k) Electronically supplied services, such as those referred to in Annex II.

RVD 56(1) is a bit more complicated than this. It does not change the place of supply to the buyer's location for the specified services in every case, but only in four specific instances where the service involves a transaction that is (a) between taxpayers in different Member States; (b) involves a sale from within the EU to a customer outside the EU; (c) where the seller is located outside the EU and the customer is a taxpayer within the EU; and (d) where both the buyer are located outside the EU.[7] RVD 56(1) states:

> The place of supply for the following services to customers established outside the Community, or to taxable persons established in the Community but not in the same country as the supplier, shall be the place where the customer has established his business or has a fixed establishment for which the service is supplied, or, in the absence of such a place, the place where he has his permanent address or usually resides:

To demonstrate the complexity of these rules consider the performance of consulting services by a French business. If services are rendered to a French customer, French VAT will apply (domestic transaction); if they are rendered for an Italian taxable person, Italian VAT will apply (RVD 56(1)). However, if the same consultation services are provided to an Italian consumer, French (not Italian VAT) will apply (RVD 43 is used as a fall-back). If these services are rendered for a Swiss customer no EU VAT applies (RVD 56(1)), but a Swiss VAT may be applicable depending on the VAT law in this non-EU jurisdiction.

In the last case, where French consulting services are supplied to a customer located in Switzerland, the EU VAT contemplates the possibility that these services will escape taxation all together. This would be the case if there is no provision in the Swiss VAT to impose a tax based on the location of the customer. The EU VAT however clearly tries to avoid the other possibility – double taxation. This would occur if a French VAT were to be imposed (based on the location of the provider – France) and a Swiss VAT was imposed (based on the location of the customer – Switzerland).[8]

CZECH REPUBLIC RULES

There are five basic fact patterns where the new Czech rules will change the place of supply for the intangible services listed in RVD 56(1). In each case the new rules will move the place of supply from outside the Czech Republic to within the Czech Republic. Each of these patterns will be considered separately, and are listed below:

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[7] In an earlier draft of this paper posted on SSRN exceptions (c) and (d) were omitted. While the omission of (d) may not have been critical to this analysis, the omission of (c) was a significant error. This paper is revise to take this omission into account. The most notable change is the elimination of two of the five fact patterns considered under the Czech Republic analysis. Personal e-mail communication Marcus Jones (Oct. 15, 2009) on file with author.

[8] At the present time there is no global standard on sourcing services and intangibles. In February 2006 the OECD Committee on Fiscal Affairs (CFA) launched a project aimed at providing guidance for governments on applying Value Added Taxes or Goods and Services Tax to cross-border trade. The goal is to produce a documenting that would offer guidance in this area, tentatively called the *International OECD VAT/GST Guidelines*. OECD, COMMITTEE ON FISCAL AFFAIRS, WORKING PARTY NO. 9 ON CONSUMPTION TAXES, APPLYING VAT/GST TO CROSS-BORDER TRADE IN SERVICES AND INTANGIBLES: EMERGING CONCEPTS FOR DEFINING PLACE OF TAXATION – OUTCOME OF THE FIRST CONSULTATION DOCUMENT (June 2008) *available at:* http://www.oecd.org/dataoecd/11/31/40931170.pdf

1. when a Czech taxable person supplies intangible services to a non-EU customer (and that buyer is also a Czech taxpayer that uses and enjoys the intangible services in the Czech Republic);
2. Omitted.;
3. when a taxable person in another EU Member State supplies intangible services to a non-EU taxable person (and that buyer is also a Czech taxpayer that uses and enjoys the intangible services in the Czech Republic);
4. Omitted;
5. when a non-EU taxable person supplies intangible services to another non-EU taxable person (and that buyer is also a Czech taxpayer that uses and enjoys the intangible services in the Czech Republic).

Some of these applications are surprising, and they are likely to catch some taxpayers unaware. This would particularly be the case where VAT compliance is not automated. The primary reason for this is that the "use and enjoyment" requirement is independent of the PE requirement. Consider for example a reasonably large company with many divisions, only one of which has a PE in the Czech Republic. If a division unrelated to the division with the PE, and without knowledge of the PE's presence in the Czech Republic, were to purchase advertising services from a Swiss or American advertizing agency, and if these services were to be used and enjoyed in the Czech Republic, then Czech VAT would be due. Without the PE, no Czech VAT would be due.

After the adoption of the Czech rules the best automated VAT compliance systems were reconfigured. Programming changes were instituted in advance to be effective on January 1, 2009. Sometime in December 2008 the system would have queried the VAT compliance staff about the presence of a PE in the Czech Republic. If that answer was affirmative, then whenever a service listed under RVD 56(1) was purchased *anywhere in the company* after January 1, 2009 a dialogue box would ask if this service was to be used and enjoyed in the Czech Republic. If that answer was affirmative, then the system would expect to find either Czech VAT on the seller's invoice, or it would institute a reverse charge of the Czech VAT.

Without this level of automation, where every RVD 56(1) service is measured for Czech use and enjoyment, it is doubtful that correct determinations would be made in all cases. Errors would be all the more likely if the services were being purchased from a jurisdiction that imposed VAT based on where the seller is established (a jurisdiction that had for example adopted a rule like RVD 43),[9] or where these service are taxed based on a "place of performance" standard (regardless of where the seller's place of establishment is located).[10] Admittedly, this would yield a double-VAT result, but it may be the correct result. The double-

[9] This is the rule in Singapore. *See*: Singapore Goods and Services Tax Act 1993 Section 13(4) (Cap 117A) (indicating that if the supplier "belongs in" Singapore, the place of supply of services is in Singapore; if the supplier belongs in another country, then the place of supply of services is in that country).

[10] The Australian GST would determine the place of supply of RVD 56(1) services with a place of performance test.

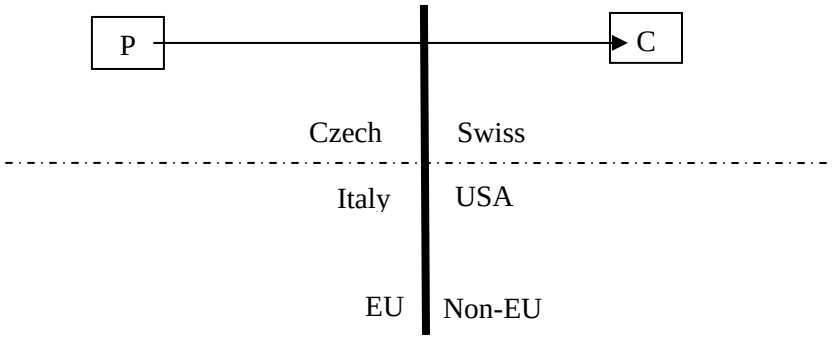
> If the service is performed in Australia, it is connected with Australia. The situs is Australia. Examples of such services include accounting services, legal services, repair services, maintenance services, preparation of, or developing, designs or other like services

GSTR 2000/31 (Goods and Services Tax Ruling), ¶183.

VAT, of course, can be prevented (or planned around) but this is much easier done through automation than it is through manual processes.

(1) When a Czech taxable person supplies intangible services to a non-EU customer.

Background rule. Under RVD 56(1) when a provider (P) of intangible services is located within a Member State, and the customer (C) is established outside the EU, the place of supply for intangible services is deemed to be where the customer is located. In the diagram below RVD 56(1) requires that Czech VAT not be imposed on sales of intangible services provided by a Czech business to a Swiss customer.



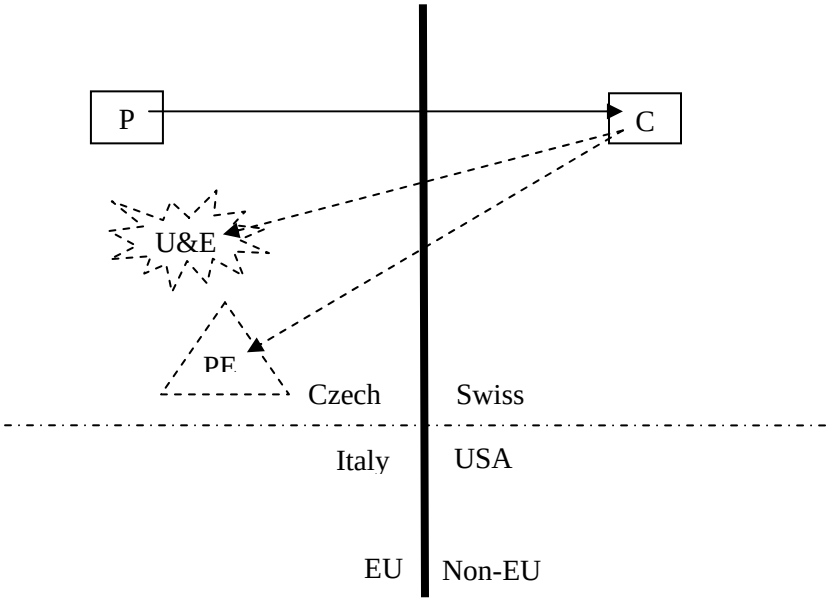
Czech Republic use and enjoyment rule. Under the new use and enjoyment rules in the Czech Republic if the customer (C) has a PE in the Czech Republic (or in the words of the statute: "…this service is provided to a person who is concurrently a [Czech tax]payer, ..."),[11] and if the intangible services are used and enjoyed in the Czech Republic, then Czech VAT will apply to these services. The standard rate is currently 19%.[12]

[11] In this discussion the term "customer" is used to reflect the usage in RVD 56(1). This expression is broad enough to include taxable businesses, exempt entities, and consumers. Because the Czech Republic modification to the standard place of supply rules in conditioned on having a PE (or a "…person who is concurrently a [Czech tax]payer, ..." the customer cannot be a final consumer. In most instances this expression "customer" will not include an exempt entity either, unless the exempt entity makes some taxable supplies. In the Czech Republic an exempt entity may not otherwise elect to be a taxpayer. The Czech VAT Act indicates:

> A taxable person who has his seat, place of business or permanent establishment in this country and only effects VAT-exempt supplies without the entitlement to VAT deduction is exempted from the liability to register himself as a VAT payer and is not eligible to file an application for VAT registration. If such person commences to affect taxable supplies and VAT-exempt supplies with the entitlement to VAT deduction, he shall have to file an application for VAT registration pursuant to subsection (1) if this person's turnover exceeds the limit laid down in section 6(1). If a taxable person opts for applying VAT on lease of plots of land, structures, flats and non-residential spaces pursuant to section 56, he may file an application for VAT registration at any time.

Czech Value Added Tax Act of 235/2004, § 95(8).

[12] Czech Value Added Tax Act of 235/2004, § 47(1)(a)



One could imagine a fact pattern where a Swiss established company with a PE in the Czech Republic decides that an advertising campaign is needed to promote sales thought Czech media outlets. If it engages a Czech advertising agency to design the campaign invoices presented after January 1, 2009 will include Czech VAT. Previous to this date invoices from this advertising firm would not include VAT.

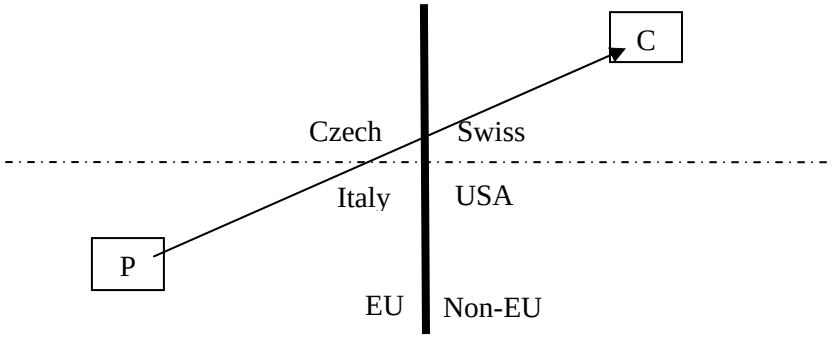
For the Czech advertizing company (P) the new Czech Republic rule turns this sale into a domestic transaction. This would be the case even though the use and enjoyment of the advertizing services is completely unrelated to the functions and operations of C's PE in the Czech Republic. It is anticipated that Czech suppliers of intangible services will be asking their non-EU clients (a) if they are a Czech taxpayer, and have a Czech VAT identification number, and (b) if the intangible services will be used and enjoyed in the Czech Republic. It will no longer matter if the services are being provided directly to the non-EU business at its place of business outside the EU.

(2) Omitted

(3) When a taxable person in another EU Member State supplies intangible services to a non-EU taxable person

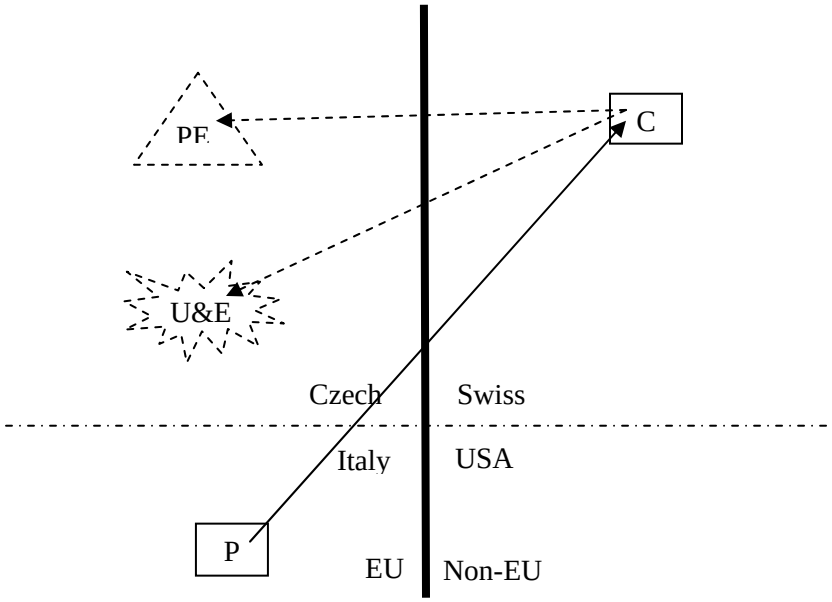
Background rule. The next permutation produces some surprises. It considers the situation where the provider (P) is established within another EU Member State, and the customer (C) is located outside the EU. As in the first example RVD 56(1) requires that Italian VAT not be imposed on sales of intangible services provided by an Italian business to a Swiss

customer. The main (or fall-back) rule under RVD 43 applies. The place of supply is deemed to be Switzerland where the supplier is located.



Czech Republic use and enjoyment rule. If however the non-EU customer has a PE in the Czech Republic, and uses and enjoys the intangible services in the Czech Republic, then Czech VAT applies. Although one might expect either Italian or Swiss VAT to apply, the application of the Czech VAT is very likely a surprise to the parties.

It would be particularly surprising to the parties if in fact the Czech PE has nothing to do with the intangible services being supplied. In a sense, the Italian VAT has given up the right to impose VAT on this transaction under the main rule (RVD 43) because of intangible services exception (RVD 56(1)) only to have another Member State tax the transaction under an application of a Use and enjoyment exception (RVD 58(b)).



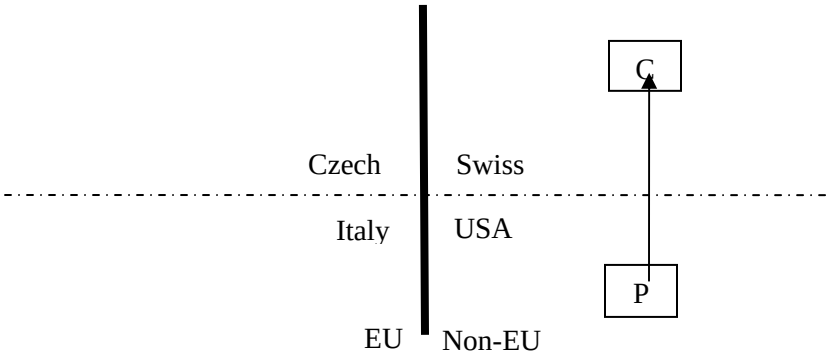
An example that would fit this fact pattern would be a Swiss company (with a Czech PE) that needed an advertizing campaign for use in Czech media outlets. If the advertizing campaign is produced by an Italian firm, and even if it is demonstrated, delivered, and accepted only at the Swiss head office, Czech VAT will apply if the campaign is used and enjoyed in the Czech Republic. The Italian provider will not be required to impose Czech VAT on its invoice. The Swiss firm however, will be required to reverse charge this amount. This will be the case even though the advertizing campaign is not in any way related to the activity of the PE in the Czech Republic.

(4) Omitted

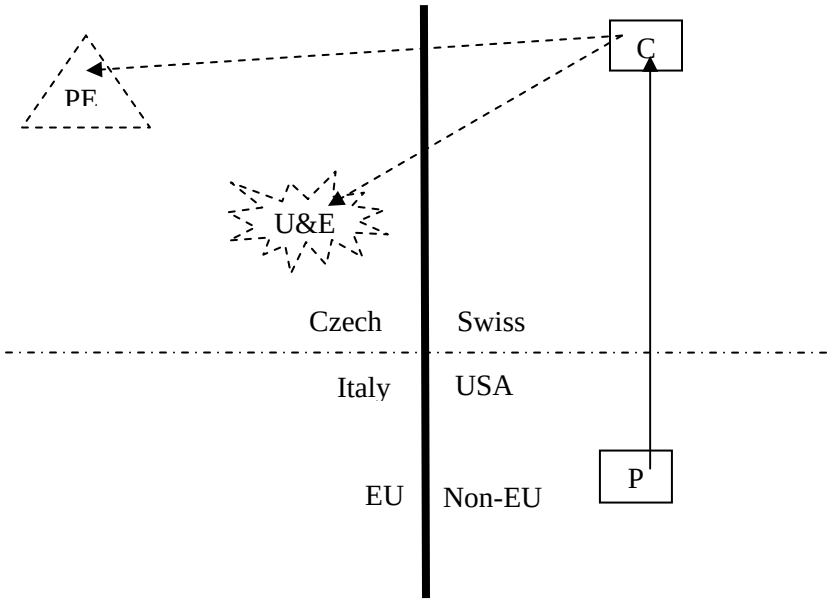
(5) When a non-EU taxable person supplies intangible services to another non-EU taxable person

Background rule. The final permutation involves two non-EU enterprises. Under the normal structure of the sourcing rules, where services are sourced either at the place where the provider's location or at that of the customer, no issues should arise. The appropriate analysis should follow RVD 43(the fall-back provision) and these services should be deemed to be taxed at the supplier's location.

In the example below a Swiss business secures intangible services from a US enterprise. From the perspective of the EU VAT these services are deemed taxable in the US, where there is no VAT.



Czech Republic use and enjoyment rule. If however the non-EU customer (in Switzerland) has a PE in the Czech Republic, and uses and enjoys the (US supplied) intangible services in the Czech Republic, then Czech VAT applies. This would be the case if a Swiss company decided to use a US advertizing firm to design its marketing materials for use through Czech media outlets. The Swiss firm would be expected to reverse charge the Czech VAT on its Czech return. This result may not be anticipated.



SUMMARY AND FINAL EXAMPLE

These scenarios sketch the rough contours of the problem that the Czech Republic felt it needed to respond to with respect to intangible services. Businesses with a taxable presence in the Czech Republic were exploiting sourcing rules to develop opportunities in the Czech marketplace without paying VAT on the value added from these services. With a VAT of 19% this exploitation tilted the playing field in favor of non-Czech and non-EU providers.

This problem manifests itself in the basic pattern at (1) above, where non-EU businesses were using Czech intangibles to develop a presence in the Czech Republic without paying VAT. The same patterns arise when other Member States are factored in. Case 3 replicates the issues in case 1. The final insult to fair play is presented in case 5. In this fact pattern non-EU businesses use other non-EU service providers to develop Czech business opportunities, without paying Czech VAT on the value added.

The Czech Republic is not the only Member State to have problems with the standard cross-border intangible service rules. The UK faced this issue with the Zurich Insurance Company, and a review of this case is helpful in understanding why other Member States have taken advantage of RVD 58 to derogate from these rules. *Zurich Insurance Company v. HMRC*[13] follows a case 5 fact pattern.

Zurich Insurance

[13] Zurich Insurance Company v. HMRC (LON/02/1080) (June 30, 2005); reversed [2006] EWHC 593 (Ch); [2006] STC 1694 (Mar. 23, 2006); affirming the reversal [2007] EWCA Civ 218; [2007] STC 1756 (Mar. 15, 2007).

Facts. From mid-1998 through 2000 the Zurich Insurance company, a Swiss company established in Zurich, Switzerland (Zurich-HO) was engaged in the global installation of a SAP financial accounting system. Part of the installation was at the London branch (Zurich-UK). The world wide installation would take place in 70 business units, in 50 countries, and would take more than two and a half years to complete. Consultancy services on the installation were provided by another Swiss company, PricewaterhouseCoopers AG (PwC – AG). Performance of the London installation was sub-contracted to the PwC affiliate in London (PwC-UK).

The issue in this case is the place of supply for consultancy services, an intangible service specified in RVD 56(c). Her Majesties Revenue and Customs (HMRC) asserted that the place of supply was in the UK and presented Zurich Insurance with a VAT assessment of £2,085,153. Zurich Insurance contested the assessment on the basis that place of supply of the services was Switzerland – where it was established. This was the case (according to Zurich) even though performance as well as substantial use and enjoyment of the consultancy – the software installation – occurred at its fixed establishment in London (Zurich-UK).

Strategic plan. Minimizing VAT exposure was import for Zurich. It provided exempt insurance supplies, and as a result, almost all of the VAT it incurred became a real business cost – it was not deductible.

Invoicing for the consulting services was considered carefully by Zurich and PwC. Three options were examined: (1) PwC-UK would bill Zurich-UK followed by Zurich-UK re-billing Zurich-HO; (2) PwC-AG would bill Zurich-UK followed again by Zurich-UK re-billing Zurich-HO; and (3) PwC-AG would bill Zurich-HO, followed by Zurich-HO re-billing Zurich-UK.[14] Although the first invoicing method was used initially (early in 1999 for the first Work Order),[15] it was quickly recognized that the third was the most "tax efficient," and was adopted (for Work Orders 2 through 10).

If (as it did under the first Work Order – using the first option) the PwC-UK affiliate billed the Zurich-UK branch for installation service the supply would be domestic. UK VAT would be due, and this would increase the real cost of the installation by 17.5%. The internal branch-to-head office (Zurich-UK to Zurich-HO) re-billing of the fee was outside the scope of VAT.

However, if (as it did under the second through tenth Work Orders – using the third option) PwC-AG billed Zurich-HO the outcome was much better. Initially Swiss VAT would apply, and the internal re-billing of the charge by Zurich-HO down to Zurich-UK would be ignored as an intra company charge. Swiss VAT rate is 10% lower than the UK VAT – 7.5% rather than 17.5%. But even more beneficial was the ability of Zurich-HO to reclaim the entire Swiss VAT when it re-invoiced the consulting service outside of Switzerland.[16] Swiss law exempts VAT on services used and enjoyed outside of Switzerland.

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[14] Id., at ¶¶ 5(21) & (23).

[15] When reading this case one gets the distinct impression that HMRC uncovered this issue because of the change in invoicing practices. Services that were invoiced directly (PwC-UK to Zurich-UK) in 1999 were now missing even though the installation was ongoing. Finding the re-invoicing route (internally) from Zurich-HO to Zurich-UK most likely raised the issue.

[16] *Id.*, at ¶ 5(22).

VAT Tribunal decision. At the London VAT Tribunal Zurich was successful. The case turned on an application of place of supply hierarchy in RVD 43. RVD 43 begins with " … the place where the supplier has established his business or has a fixed establishment from which the service is supplied …" Thus, the issue was whether the place of supply should be deemed to be the location of the supplier's place of establishment (PwC-AG in Switzerland), or the location of the supplier's fixed establishment (PwC-UK in London).

The Court applied the holdings of two cases *Burkholz v. Finanzamt Hamburg-Mitte-Alstadt*[17] and *Customs and Excise Commissioners v. DFDS A/S*[18] to reach its conclusion. The *Berkholz* case establishes (according to the Tribunal) that priority is given to the place of establishment (PwC-AG in Switzerland) over the place of the fixed establishment (PwC-UK in London) unless this does not lead to a "… rational result for tax purposes or creates a conflict with another Member State."[19] The *DFDS* case (according to the Tribunal) provides a set of criteria to determine when a fixed establishment is a place of supply. The Court's summary of the *DFDS* reasoning was:

> In other words, the place from which the supply of the single travel service was made was determined by where the contract was made, the documentation issued, and the consideration paid.[20]

Applying these four factors to the Zurich fact pattern, the Tribunal found that the weight of the evidence (2 to 1, with 1 factor a draw) favored Switzerland: (1) the contract was signed in Switzerland, (2) the costs were born in Switzerland, and (3) the work was performed in the UK. As to (4), the benefit was considered to be for both the UK and the Swiss entities, making this factor a draw.[21]

The Court further indicated that the UK could have derogated from RVD 56 and taxed these consultancy services on a use and enjoyment basis (under RVD 58), but had not done so.[22] The fault was the UK law, not the taxpayer. Zurich made a similar argument in a broader context:

> Determining the fixed establishment as the place of supply would result in both Swiss and UK VAT being imposed. It was not relevant that Swiss VAT was in fact recovered. The place of establishment and fixed establishment in article 9(2)(e) [RVD 56] were in contract to the "use and enjoyment" test in article 9(3) [RVD 58].

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[17] Case 168/84; [1985] ECR 2251 (concerning the place of supply for the "takings" from gaming machines placed on a ferry operating between Germany and Denmark by a German established company and whether the boat as a fixed establishment took precedence over the Hamburg, Germany place of establishment).
[18] Case 260/95; [1997] STC 384, [1997] ECR I-1005 (concerning a Danish established tour operator that marketed tours in the UK through its agent, a UK company, and which found based on the actual economic situation that the place of supply was at the UK agent, the fixed establishment).
[19] Berkholz, at ¶ 17.
[20] Zurich (LON/02/1080) at ¶ 16.
[21] *Id*., at ¶¶ 19-23.
[22] *Id*., at ¶¶ 24.

The High Court. HMRC appealed the VAT Tribunal's decision and the holding was reversed. The High Court suggests that the Tribunal made a fundamental error when it based its decision entirely on the Sixth Directive, "… at no point does the tribunal refer to any specific provision of the United Kingdom legislation."[23] The High Court notes that the Sixth Directive only provides a framework of charging provisions (the Directive itself does not impose charges), and it is the law of each Member State that imposes the tax. The rule is:

> … as long as the result of the domestic legislation is in accordance with what would be the result of the provisions in the Directive, it does not matter that the domestic legislation gets to that result by a different route. That is the effect of the third paragraph of art 249 EC of the EC Treaty (formerly art 189):
>
> > '... A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods ...'[24]

Although the approach taken by the Tribunal may not be a problem in many cases, it is a particularly bad approach in this case. The High Court indicates:

> … the place of supply rules are differently constructed [under the UK VAT Act], at least for supplies of services. Whereas in the case of the Directive the place of supply of services may be where the supplier is located or where the recipient is located, depending on whether art 9(1) or 9(2) applies, under s 7(10) of the VATA (reproduced in para 18(ii) above) all supplies of services are treated as made where the supplier 'belongs'. That place is determined by reference to s 9(2) (see para 18(iii) above), and depends on the location of his or its (the supplier's) business establishment or establishments. <u>There is no rule in the VATA like art 9(2)(e) of the Sixth Directive, under which supplies of certain services are taken to be made in the country where the recipient is established or has a fixed establishment</u>.[25]

In other words, the four-part *Berkholz* hierarchy (the place where a business is established; the fixed establishment from which the service is supplied; the permanent address; the place of usual residence) is absent from the UK VAT Act (VATA). UK sourcing determinations are controlled by a more flexible rule – the issue is to find out where the recipient of services "belongs." As a consequence, there are two steps (not one) in a proper analysis: (1) what is the result under the VATA, and (2) is this result consistent with the Sixth Directive?

First, the High Court indicates why the Zurich Insurance company is liable for UK VAT under a straight application of the VATA.

- Consultancy services are a "specified service" (VATA § 8(2));
- Consultancy services were provided by a person who "belonged" in a country other than the UK [PwC-AG "belong" in Switzerland] (VATA §8(1)(a));
- Consultancy services were received by the Zurich Insurance company for the purpose of the business carried out by it (VATA § 8(1)(b)), and most importantly;

[23] Zurich, [2006] EWHC 593 (Ch); [2006] STC 1694 (Mar. 23, 2006) at ¶ 30.
[24] *Id*., at ¶ 22.
[25] *Id*., at ¶ 21 (emphasis added).

- Zurich Insurance company was a person who "belonged" in the UK (VATA §9(4)), because;
- The Zurich Insurance company has business establishments in more than one country, so that under VATA § 9(4)(b) it is considered to "belong," with respect to any particular service received by it, in the country containing the establishment at which the services are most directly used.

Thus, the High Court then concluded, "… that country [the country containing the establishment at which the services are most directly used] can only be the United Kingdom."[26]

The next step is to confirm that this result (sourcing the consultancy services in the UK) is consistent with the result required under the Sixth Directive. The test is whether or not the result under the VATA is "rational result."

> … the word 'rational' is used in most of the ECJ cases which have been concerned with the place of supply of services. The ECJ consistently links rationality in this context with the avoidance of conflicts of jurisdiction, of double taxation, and of non-taxation.[27]

The High Court cites *Berkholz*,[28] *DFDS*,[29]and *RAL (Channel Islands) Ltd. V. Customs and Excise Commissioners*.[30]

Locating the place of supply within the United Kingdom, subjecting the Zurich Insurance company to UK VAT meets the "rational result" standard. Double taxation is not in issue (because two or more Member States do not have overlapping jurisdiction).[31] However, both non-taxation and distortion of competition arise under the Tribunal's, but not under the High Court's holding. Non-taxation occurs when services are consumed within the Community but are not subject to VAT, and this would clearly be the case if the consultancy effort that installed SAP in the London branch of Zurich Insurance was not subject to VAT.[32] Competition would be distorted under the Tribunal's decision, because if a local consultant provided them they would be required to add the 17.5% VAT to the invoice.[33]

Court of Appeal. The Court of Appeal agreed with the High Court that the "only tenable" outcome of the proper application of the Sixth Directive in this case is the conclusion that the place of supply of the consulting services was the UK, and UK VAT is due.

CONCLUDING APPLICATION

Some EU jurisdictions, like the Czech Republic, have transposed the sourcing rules for intangible services into local law by reproducing the wording of RVD 43 and RVD 56(1). Other EU jurisdictions, like the UK, have constructed a different sourcing formula; one that is more

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[26] *Id*., at ¶ 27.
[27] *Id*., at ¶ 43.
[28] Berkholz, at ¶¶ 14 & 17.
[29] DFDS, at ¶ 22.
[30] Case C-452/03 [2005] STC 1025 at ¶ 33.
[31] Zurich, [2006] EWHC 593 (Ch); [2006] STC 1694 (Mar. 23, 2006) at ¶ 48.
[32] *Id*., at ¶ 49.
[33] *Id*., at ¶ 50.

flexible, but which nevertheless achieves the same result as those intended by the Sixth Directive.

RVD 58 recognizes that the sourcing rules for intangible services can be used in a manner that results in double taxation, non-taxation or distortion of competition. It allows Member States to derogate from these rules for "any or all" of the RVD 56(1) services in cases where the normal rules would place the supply outside the Community (RVD 58(b)), or where the normal rule would place the supply of services within their territory (RVD 58(a)). "Use and enjoyment" is the standard that must be used in this derogation.

The Zurich Insurance case shows both how problems can arise, and how they can be resolved in this area. The problems (seen in the VAT Tribunal's decision) come from reading the law and the cases (particularly the *Berkholze* case) too literally – finding rigid hierarchies where "rational results" are the real goal. The UK VATA gets the right result, but so too does the Czech Republic VATA – after the most recent modification. If the Zurich Insurance case arose under the present Czech rules Czech VAT would clearly be due. The presence of a branch within the Czech Republic (a PE) together with consultancy services supplied by a provider established outside the Community would require the use of a reverse charge.

Legislators considering the problem of sourcing rules for intangible services might be well advised to factor into their analysis how this change would impact automated VAT compliance. The Czech decision to have the "use and enjoyment" requirement independent of the PE requirement did present some problems, although not as many as the very flexible UK use of the "belonging" rule as the sole linchpin in their analysis does. "Belonging" is a bit more difficult to automate than is the four part RVD hierarchy supplemented with a PE and a "use and enjoyment" criteria.

Because notice of the Czech rule change was presented well in advance of its effective date the best automated VAT compliance systems in the Czech Republic were reconfigured to process invoices under the new rules precisely on January 1, 2009. This is the kind of cooperative legislative change that adds to the overall efficiency of the revenue system.