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# Editorial

## *Making VAT as Neutral as Possible*

**Prof. Han Kogels**

Since the 1960s, Value Added Tax (VAT, sometimes referred to as 'GST' or Goods and Services Tax) has grown into the most preferred and most robust broad based consumption tax in more than 150 countries worldwide (including all OECD Countries, with the exception of the USA) accounting on average for about 20% of the total tax revenue.[1] The leading principle of VAT is neutrality. Being collected by businesses at each stage of the production and distribution chain, businesses are charged VAT on the inputs they buy to produce further goods or services, but can deduct (or recover) that input-VAT from the output-VAT they charge on the price of the good or service they sell to the next supplier. Eventually the total tax collected throughout the chain should correspond to the VAT paid by the final consumer. The final consumer bears the VAT at the rate applicable, irrespective of the number of transactions in the production and distribution chain (internal neutrality). Moreover, VAT taxes importation and zero-rate exports, thus not affecting international trade ('external neutrality' or 'destination principle').

As a result of the fast growing globalization of international trade, and in particular of cross-border services including e-commerce, the interaction between VAT/GST systems operated by individual countries has become more sensitive to double taxation and unintentional non-taxation. Since the late 1990s, discussions between the OECD's Committee on Fiscal Affairs (CFA) and international business revealed that the current international consumption taxes environment, especially with respect to trade in services and intangibles, is creating obstacles to business activity, hindering economic growth and distorting competition and therefore requires remedies. In its report 'International VAT/GST Guidelines' (2006), the Centre for Tax Policy and Tax Administration of the OECD explained the road towards a set of framework principles on the application of consumption taxes to the trade in international services and intangibles as the first part of the OECD VAT/GST Guidelines. The object is to develop these principles in a way that countries (both OECD and non-OECD) can implement them in legislation. In July 2011, six International VAT Neutrality Guidelines were approved by the CFA of the OECD. In June 2012, the CFA published its draft Commentary on these guidelines, emphasizing that this is still work in progress and that one or another country may not be in full agreement with one or more of its provisions, but that input from stakeholders (individuals, industry bodies or professional advisory firms) will be extremely helpful to further develop these guidelines.

The draft Commentary aims at providing guidance for the implementation of these six International VAT Neutrality Guidelines in practice. These Guidelines and the Commentary should be read and understood as a coherent whole, and in the light of the more general International VAT/GST Guidelines.

In its draft Commentary, the CFA first explains that the Guidelines specify that, for internationally traded business-to-business (B2B) supplies of services and intangibles, the application of the destination principle is, in most cases, best achieved by allocating the taxing rights to the jurisdiction (country) in which the business customer is located (the 'Main Rule'). Therefore it is recommended that, instead of the supplier, the business customer should be liable to account for VAT due through the 'reverse-charge' mechanism, where that is consistent with the national consumption tax system in the country of the customer.

Whereas the widest application of the Main Rule is recommended in order to achieve VAT neutrality in cross-border situations, different interpretations of the place of taxation rules and limited right of deduction of input-VAT (also in case of reciprocity requirements for refund of foreign VAT) may lead to loss of neutrality. The six Guidelines and the draft Commentary underpinning them can be summarized as follows. For the sake of a better understanding, some situations will be illustrated hereinafter with the help of an example in which BCx is a taxable business located in country X, purchasing services or intangibles from either BSx, a taxable business in the same country, or from BSy, a taxable business located in country Y.

[1] Jeffrey Owens & Piet Battiau, *VAT's next half century: Towards a single-rate system?*, in OECD Observer No. 284, Q1 2011. Within the OECD, VAT systems represent on average 18.7% of total tax revenues.

**Guideline 1** ***The burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation.***

Let us first go into a domestic B2B transactions in country X where 15% VAT is applied on goods or services. Let us assume the price is 100 excluding VAT. BSx charges 15% VAT (output-VAT) to his customer BCx, and the customer pays 115 to his supplier. The supplier pays 15 VAT to the fisc of country X, and insofar as the customer uses these goods and services for his taxable transactions, he deducts (or claims back) that VAT (input-VAT) in his own VAT return. The VAT burden for both trading partners is nil and therefore in line with the neutrality principle of VAT.

In cross-border transactions, neutrality can be achieved by the Main Rule according to the destination principle: the place of taxation of services and intangibles is the country where the BCx is located. So services or intangibles sold by BSy are subject to 15% with BCx in country X who has the right to deduct that VAT.[2]

However, in some instances business customers may incur VAT in countries where they cannot recover that input-VAT by deduction through the same procedures as domestic businesses. The draft Commentary to this Guideline simply states that foreign businesses should not bear the burden of the VAT itself, except where provided for in legislation. The latter refers to the situation in which country X limits or blocks the deduction of input-VAT by BCx (e.g., because it uses the services bought for exempt transactions, or if the input-VAT relates to purchases that are not wholly used for furtherance of taxable business activity), Guideline 1 and its Commentary consider this as being in line with the sovereignty of that country and therefore not being in conflict with the neutrality principle.

**Guideline 2** ***Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation.***

'Similar levels of taxation' refers to the burden borne by a taxable person. When a business without full right to deduct input tax incurs VAT in different jurisdictions, it should bear the burden of the VAT only once on each input. If such a business were to incur irrecoverable tax in one or more different jurisdictions on the same input, it would not bear a similar level of taxation compared to another business in a similar situation (i.e., also without full right to deduct input tax) which acquired its inputs solely within the domestic market. The similarity of transactions, as mentioned in this Guideline, refers to the characterization of the particular services or intangibles being supplied. That characterization (definition) may not be consistent across jurisdictions. Although the wording of the draft Commentary is not quite clear, it can be understood that, according to the CFA, it is important to consider the definition of the supply under the rules in the jurisdiction (country X in the example above) in which the business (BCx) is acquiring its inputs from other jurisdictions or domestically. In fact, this would be in line with the country of destination principle.

As Guideline 3 *Goes into situations which are inconsistent with Guideline 4, I hereafter first summarize the draft Commentary on Guideline 4.*

**Guideline 4** ***With respect to the level of taxation, foreign businesses should not be disadvantaged nor advantaged compared to domestic businesses in the jurisdiction where the tax may be due or paid.***

Whereas Guideline 2 deals with equity of treatment for businesses in similar situations carrying out similar transactions, Guideline 4 focuses on the avoidance of any positive or negative discriminatory application of the rules (e.g., because foreign businesses are subject to irrecoverable input-VAT compared to domestic businesses), leading to a different VAT burden, simply because a business is foreign. In other words, VAT should not distort competition between foreign and domestic businesses.

**Guideline 3** ***VAT rules should be framed in such a way that they are not the primary influence on business decisions.***

If, as a result of inconsistency with Guideline 4, foreign businesses are advantaged compared to domestic businesses, in respect of the level of the VAT burden, a business may decide to operate from offshore rather than in the domestic jurisdiction. So businesses may try to achieve neutrality that does not exist. The draft Commentary indicates that some reactions from businesses are an indication of impact by the VAT legislation (such as whether a business decides to operate in a jurisdiction, sell to customers in a jurisdiction, make purchases from a vendor in a jurisdiction, outsource activities to be carried out in a jurisdiction, structure its supply chain or make use of intermediaries), whereas other business decisions are not relevant (such as deciding not to purchase or sell items on which there is a block on input-VAT credits,

[2] In its draft Commentary, the CFA gives the example of exports that are zero-rated with supplier BSy in country Y and imports are subject to 15% VAT with BCx in country X, with the right to deduct that VAT; this is somewhat confusing, because the Guidelines are focused upon services and intangibles.

altering products or services to take advantage of different tax status, or taking advantage of simplified methods of calculating taxes due, which may be available to smaller suppliers).

### Guideline 5 *To ensure foreign businesses do not incur irrecoverable VAT, government may choose from a number of approaches.*

The draft Commentary on this Guideline emphasizes the importance of seeking approaches to ensure that foreign businesses do not incur irrecoverable input-VAT. The draft Commentary mentions a not limited number of approaches, such as making supplies free of VAT, allowing foreign businesses to obtain a refund through a specific regime or through local VAT registration, shifting the responsibility to locally registered suppliers/customers or granting purchase exemption certificates.

Refund of (foreign) input-VAT may, as we know, lead to VAT fraud. However, where governments try to protect their tax bases from fraud by anti-fraud measures, they should, according to the draft Commentary, take such measures in balance with the objective of keeping compliance and administrative costs as low as possible. Although a direct refund system that applies a *de minimis* threshold for refund in a cost-efficient way would meet the neutrality objective, a registration system that does not allow refunds unless taxable supplies are made in the local jurisdiction by the non-resident business may not adequately meet the neutrality objective.

### Guideline 6 *Where specific administrative requirements for foreign businesses are deemed necessary, they should not create a disproportionate or inappropriate compliance burden for the businesses.*

Domestic businesses and foreign businesses have different characteristics as regards legal presence, local staff or links to the tax authorities. Although the International VAT Neutrality Guidelines recognize that the administrative requirements for domestic and foreign businesses may not be identical, any specific rules and requirements on foreign businesses should be taken in a way that minimizes their impact on neutrality and should not be disproportionate or inappropriate. Such specific rules or practices (e.g., audits) should not be a disguised form of discrimination and should meet the guiding Principles of Good Tax Administration.[3] For example, when documentation is required to support a refund claim (possibly in the language of the country where the claim is lodged), it should be limited to the documents that are necessary to the assessment of the validity of the claim.

## Call for dialogue

The draft Commentary on the International VAT Neutrality Guidelines can be a new step forward to improving the VAT, though certainly not the final step. The dialogue between the stakeholders should be continued in order to achieve robust and workable VAT-systems worldwide that are as neutral as possible. We are looking forward to learning the stakeholders' reactions to this draft Commentary.[4]

[3] General Administrative Principles, approved in 2001 by the OECD Forum on Tax Administration.

[4] Comments should be sent to the OECD by 26 Sept. 2012.