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Editorial

Base Erosion and Profit Shifting and Value Added Tax in the Digital Economy

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In the final report on Action Point 1 of the Organisation for Economic Co-operation and Development (OECD)/Group of Twenty Base Erosion and Profit Shifting (BEPS) Project, 'Addressing the Tax Challenges of the Digital Economy' (hereinafter 'BEPS Report'), attention is paid to Value Added Tax (VAT)/Goods and Services Tax issues raising BEPS concerns. Not surprisingly these issues focus solely on digital services (in a broader sense: intangibles) acquired and used by businesses (taxable persons for VAT) for providing VAT exempt services such as financial and insurance services. Input-VAT invoiced to the business customers acquiring such digital services to be used for VAT exempt transactions is not deductible or recoverable. This intended (though neutrality distorting) 'tax cascading' effect of a VAT exemption within the business-to-business (B2B) chain leads to a 'hidden' input-VAT in the cost price of the services provided by the banks. No wonder that VAT-exempt businesses feel the temptation of developing cross-border business models avoiding VAT and also hidden VAT. And therefore no wonder that the BEPS Report addresses this issue. The Report goes into two problem areas: the remote digital supply of services in general and the remote digital supply of services to a multi-location enterprise.

1 Remote digital supplies of services

In most countries (including European Union [EU] Member States) a B2B cross-border digital supply of services to a business customer is not taxable in the country of the supplier, but in the country of the customer. This leads to so called 'reverse charge of VAT', which means that the foreign supplier does not charge VAT and the business customer is required to self-assess and pay VAT (as if it were input-VAT) at the rate of the country in which the digital service is acquired. For example, if the business customer is a bank, performing VAT-exempt transactions, it is not entitled to claim a credit for the self-assed VAT.

One of the problems identified in the BEPS Report refers to the situation in which the business customer is a bank established in a (non-EU) country that does not require VAT-exempt businesses to self-assess VAT on such services. If the supplier is established in a country following the destination principle (in for example the EU), no VAT is charged and thus there will be no VAT on the transaction.

Some countries outside the EU do not follow the country of destination principle and consider the country of the supplier as the 'place of taxation'. Here we can identify two problems. First, if the business customer is a bank established in a (non-EU) country that does not require self-assessment, it may either pay no VAT at all if such digital services are not subject to VAT in the (non-EU) country of the supplier, or the bank will pay the VAT due and invoiced by the supplier at a rate that could be lower than the rate in the country of the business customer. In the latter case, the VAT accrues to the country of the supplier (the country of origin) and not to the country of destination. In either situation, similar suppliers in the country of the bank could face potential distortion of competition from foreign suppliers (of course unless the applicable VAT rate in the country of the supplier is higher than the rate in the country of the bank, but the BEPS Report does not mention this).

The second problem arises if the supplier (in a non-EU country) charges VAT on digital services to a bank in the EU where self-assessment is required. In this case the bank will bear 'double VAT', as it will pay the (foreign) VAT charged by the supplier and the self-assessed VAT in its own country as well. The BEPS Report does not go into this problem, but more generally refers to the Consumption Tax Guidelines of the OECD (2003) where the Committee on Fiscal Affairs stated that 'in order to avoid double taxation, the country of the business presence that has acquired the supply may choose to provide a correction proportionately to the tax collected by the other country'. One may wonder why the OECD used the words 'may choose to' instead of 'shall', as the neutrality principle of VAT requires the avoidance of both double taxation and double non-taxation.

The BEPS Report – referring to Guideline 2 of the OECD Consumption Tax Guidelines – recommends as a general rule the application of reverse charge VAT on cross-border B2B supplies of digital services to the customer who is required to self-assess VAT at the applicable rate in his country, i.e. the system applied in the EU.

2 Remote digital supplies to a multi-location enterprise

As the BEPS Report notes, it is common practice for a multinational business (multi-location enterprise [MLE]) to initially acquire digital services centrally and recharge the cost to its establishments using these services on various locations in other countries. If there are no establishments using such services for VAT exempt business activities, it makes no difference whether VAT jurisdictions apply VAT or not to transactions that occur between establishments of an MLE, as any (self-assessed) input-VAT can be recovered. However, where establishments of a multi-location bank use digital services for exempt transactions, they would normally not be entitled to VAT paid on their inputs. However, in order to acquire digital services for all its establishments worldwide, a multi-location bank could centrally acquire such services in a country without VAT (see above) and share these with (and recharge the cost to) all its establishments without incurring any input VAT.

This MLE problem as addressed in the BEPS Report seems to be very much inspired by the Skandia Case that played in the (VAT exempt) insurance sector.[1] In that case, digital services were externally acquired by an establishment of the Skandia Group (Skandia America Corporation [SAC]) in the United States and then redistributed to other establishments (branches), including an establishment in Sweden (Skandia Sverige) that was included in Skandia's Swedish VAT group. Internal invoices were used to allocate the costs of these services between SAC and Skandia Sverige. For an interesting analysis of the Skandia Case and its consequences, I refer to the article by Van Norden in this issue of EC Tax Review.[2]

With respect to this issue in the field of multi-location enterprises, the BEPS Report refers to the recommendation in Guideline 4 of the OECD Consumption Tax Guidelines which is based upon the principle that VAT should accrue to the country where the customer's establishment (branch) using the digital service is located. This means that the right to levy VAT on such services should be allocated to the country where these services are (effectively) used for business purposes, irrespective of how the supply and acquisitions of these services were structured. It would be interesting to further consider the pros and cons of the introduction of such 'effective use proxy' for digital B2B services in the EU VAT Directive.

1 ECJ 17 Sept. 2014, Case c-7/13 *Skandia America Corporation*, ECLI:EU:C2014:2225.

2 Prof. Dr. Gert-Jan van Norden, *State of Play in Respect of the Skandia America Corporation Case*, EC Tax Rev. xxxx (2016-4)