The Future of VAT through the Eyes of OECD

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OECD Guidelines

OECD International VAT/GST Guidelines – last edition – April 2014

Purpose: The guidelines (evolutionary nature) seek to identify the objectives and suggest means for achieving them

Not aimed at detailed prescriptions for national legislation.

OECD Guidelines

Chapters of the International VAT/GST Guidelines:

Chapter 1: Core Features of Value Added Taxes

Chapter 2: Neutrality of VAT in the Context of Cross-Border Trade

Chapter 3: Determining the Place of Taxation of Cross-Border Supplies of Services and Intangibles

OECD Guidelines

Chapter 1: Core Features of Value Added Taxes

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Chapter 1: Core Features of VAT

Purpose of VAT: impose a **broad-based** tax on **consumption**.

- *Final consumption* - usually by households, but sometimes also by entities;

- *Broad-based* - covers a large spectrum of transactions (e.g. excise duties - limited spectrum of transactions).

Consequence: The burden of VAT should not rest on business

Chapter 1: Core Features of VAT

Central design feature of VAT: staged collection process

- Each business in the supply chain takes part in controlling and collecting the tax and remits tax corresponding to its margin;

- Two principle approaches are available:
    - Invoice-credit method (used by most jurisdictions);
    - Subtraction method.

Chapter 1: Core Features of VAT

VAT and international trade: the destination principle

Fundamental issue: whether tax shall be levied:

- in the jurisdiction of origin (where value is added), or

- the jurisdiction of destination?

Chapter 1: Core Features of VAT

Destination principle widely preferred as:

- Places all firms competing in a single jurisdiction on an even footing;

- Achieves neutrality in international trade - zero-rated exports, tax paid at the same rate as domestic supplies in the jurisdiction of consumption;

(continued)

Chapter 1: Core Features of VAT

Destination principle *(continued)* widely preferred as:

- Relatively straightforward and generally effective in practice – largely due to the existence of borders or fiscal frontiers (for goods)

- Difficulties with services or intangibles overcome via the reverse charge mechanism (rules may differ from country to country);

Chapter 1: Core Features of VAT

Generally accepted principles of tax policy to VAT:

a/ Neutrality

- tax should be neutral between e-commerce and conventional commerce,

- business decisions shall be motivated by economic rather than tax considerations,

- taxpayers in similar situations carrying out similar transactions shall be subject to similar taxation.

(continued)

Chapter 1: Core Features of VAT

Generally accepted principles to VAT *(continued)*:

b/ Efficiency – compliance costs for business and administration shall be minimised;

c/ Certainty and simplicity – tax rules should be clear and simple to understand;

d/ Effectiveness and fairness – taxation should produce the right amount of tax at the right time;

e/ Flexibility – systems for taxation should keep pace with technological and commercial developments

OECD Guidelines

Chapter 1: Core Features of Value Added Taxes

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Chapter 2 – Neutrality of VAT

Neutrality of VAT in the Context of Cross-Border Trade

Basic neutrality principles:

A. Domestic and International

1. The burden of VAT should not lie on taxable businesses unless explicitly provided for by the law.

Examples:

-Transactions made by business are exempt because tax base of outputs is difficult to assess (many fin. services) or for policy reasons (health care, education, culture, etc.)

(continued)

Chapter 2 – Neutrality of VAT

Examples (continued):

-Business makes transactions out of scope of VAT (e.g. free of charge or not fully used for taxable business).

- Business does not meet specific administrative obligations (e.g. insufficient evidence to support input tax deduction).

Chapter 2 – Neutrality of VAT

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

This is to ensure that the tax ultimately collected along a particular supply chain shall be equal to the tax paid by the final consumer (regardless of the type of transaction, length of distribution chain, technical means used, etc.).

Chapter 2 – Neutrality of VAT

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

Example: VAT rules should not induce a business to adopt a specific legal form (e.g. branch or subsidiary)

Chapter 2 – Neutrality of VAT

B. International

1. With respect to the level of taxation, **foreign businesses should not be advantaged or disadvantaged** compared to domestic businesses:

   VAT systems should not distort international trade or limit consumer's choice. This is achieved by exemption of exports and taxation of exports at the same rate as domestic supplies.

Chapter 2 – Neutrality of VAT

2. Foreign business should not incur irrecoverable VAT.

Possible approach to achieve this:

- direct refund;
- make supplies free of VAT;
- enable refunds through local VAT registration;
- shift responsibility on to local suppliers/customers;
- granting purchase exemption certificates;

A combination of approaches may be used.

Chapter 2 – Neutrality of VAT

3. **Administrative requirements for foreign business should not create disproportionate or inappropriate compliance burden** (i.e. discrimination should be avoided).

Administrations could impose specific compliance requirements to certain categories of business: e.g. small enterprises, enterprises in specific businesses or to foreign businesses.

Dealing with business with no “legal” presence is a challenge for both sides: avoidance/evasion against significant administrative burden or discrimination.

OECD Guidelines

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Chapter 3 – Place of Taxation

Place of Taxation of Cross-Border Trade of Service and Intangibles

The Destination Principle - for consumption tax purposes internationally traded services and intangibles should taxed according to the rules of the jurisdiction of consumption.

To apply the destination principle there have to be a mechanism to identify the destination where the final consumption takes place.

Chapter 3 – Place of Taxation

For **goods** – the determining of the place of taxation is facilitated by the existence of border controls or fiscal frontiers.

Services and intangibles – no border control so different rules are needed and Chapter 3 concentrates on services and intangibles.

Chapter 3 – Place of Taxation

The rules should ensure that:

- International neutrality is maintained;
- Compliance – as simple as possible;
- Clarity and certainty for both business and administration;
- Compliance costs – minimal;
- Barriers to evasion and avoidance – sufficiently robust;

Chapter 3 – Place of Taxation

Place of supply rules

Business to Business (B2B)

Business to Consumer (B2C)

Chapter 3 – Place of Taxation

Business-to-business **(B2B)** transactions, taxed under the VAT staged process.

Objective - the rules for place of taxation would facilitate the ultimate objective to tax the final consumption

- Flow through of the tax burden;

- Purchases are used to create goods, services or intangibles that the final consumers would acquire.

Chapter 3 – Place of Taxation

Business-to-consumer **(B2C)** transactions

Objective - the rules for place of taxation should identify the place where the final consumption takes place.

Tax is charged at or before the time consumption takes place – this creates practical difficulty to identify the place of final consumption.

Chapter 3 – Place of Taxation

To overcome the difficulties – the VAT systems use proxies (different for B2B and B2C).

Jurisdictions are encouraged to provide clear practical guidance on how the suppliers could establish the status of their customer . Suggestions:

- VAT number (with easy-to-use system for verification);
- Commercial register;

Chapter 3 – Place of Taxation

B2B Guidelines

1. For B2B supplies, the jurisdiction in which the customer is located has taxing rights

2. The identity of the customer is normally determined by reference to the business agreement (*irrelevance of onward supplies, physical deliveries to a third party, payment flows*)

3. For customers established in more than one jurisdiction the taxing rights accrue to the jurisdiction where the establishment using the services or intangibles is located.

Chapter 3 – Place of Taxation

B2B and B2C Guidelines

<u>Specific rules</u>

Conditions:

- Taxation at customer location does not produce an appropriate result, and
- A proxy other than customer location leads to a significantly better result.

Examples: Services/intangibles directly related to immovable property or other tangible property.

Chapter 3 – Place of Taxation

B2C - Historically:

Consumers typically purchased supplies from local suppliers. Therefore many jurisdictions used the supplier's location as a reference (main rule).

Specific rule (usually) – performance based – entertainment events, sports events, etc.

However emergence of global economy and growing reliance on digital supplies has created challenges to the traditional approach.

Chapter 3 – Place of Taxation

B2C Guidelines

On-the-spot supplies – taxed at the place of physical performance

- Physically performed at a readily identifiable location, and
- Ordinarily consumed at the same time/place where performed,
- Ordinarily require the physical presence of both the persons performing and consuming the supply.

!N.B. Jurisdictions could apply a similar rule for B2B supplies

Chapter 3 – Place of Taxation

B2C Guidelines

Other B2C supplies (main rule) of services and intangibles – the jurisdiction where the customer has his usual residence should have the taxing rights

Major issues:

- Determining the location of the customer
- VAT collection from non-established suppliers

Chapter 3 – Place of Taxation

B2C Guidelines

Determining the location of the customer

- High volume and low value;
- Minimum interaction and communication;

Information to be used:

- available at the time of taxation;
- collected in the normal course of business (bank details, IP address, credit card info) – evolve over time;
- reliable.

Chapter 3 – Place of Taxation

B2C Guidelines

<u>VAT collection from non-established suppliers</u>

- Traditional approach – registration in the jurisdiction of taxation (complex and burdensome);
- Reverse-charge – hardly applicable for end consumers;
- Simplified registration regime – currently viewed as the most effective regime.

Chapter 3 – Place of Taxation

B2C Guidelines

<u>Simplified registration</u>

Registration – information limited to the necessary details only (online);

Input tax recovery – could be limited to direct refunds;

Returns – simpler than returns for local business (online);

Payments – e-payments recommended;

Chapter 3 – Place of Taxation

B2C Guidelines

Simplified registration (continued)

Records – limited to what is needed, automated, etc.

Invoicing – simplified or issued under the supplier's jurisdiction rules;

Availability of information – online info an administration's web-sites;

Use of third party service providers – should be allowed.