OECD Aims to Ease VAT's Impact on International Trade in Services, Intangibles

By Rick Mitchell

PARIS—A group of experts from business and government will meet at the Organization for Economic Cooperation and Development in September to develop solutions to a growing global tangle of conflicting value-added tax systems that threatens international trade and investment, particularly in services and intangibles, sources told BNA.

The Sept. 8-9 meeting, a continuation of the organization's five-year-old effort to develop international VAT guidelines (37 DTR G-1, 2/24/06), will in particular address special problems posed by certain VAT-exempt business sectors that are structured in branches, notably financial services, they said.

The Paris-based organization, whose 34 members include some of the world's most advanced economies, has urged member states to reduce direct taxes on personal and business income and increase indirect taxes on consumption, through mechanisms such as VAT, which it said are less of a drag on economic growth.

But sources said that as more and more countries adopt VAT to raise revenues, a lack of common rules across jurisdictions has led to double taxation (56 DTR I-1, 3/23/11). Divergent requirements for invoices, reporting dates, and enterprise resource planning (ERP) systems, among other problems, are pushing up compliance costs for multinational enterprises, they said.

On the other hand, tax administrations complain that VAT complexity, compounded by globalization and rapidly changing technology, can cause unintentional nontaxation of taxable items, depriving governments of needed revenue.

Business Contributes to Debate

At its September meeting, the OECD Technical Advisory Group on VAT and Goods and Services Tax will discuss ways to improve compatibility among OECD members' VAT systems, said Piet Battiau, who took over as head of OECD's consumption taxes unit in March. The group also will develop guidance to help governments implement new OECD policy recommendations aimed at ensuring that VAT is not a cost for business, the so-called neutrality principle (135 DTR I-1, 7/14/11), and will discuss possible exceptions to this principle, notably in the case of financial services, he said.

The TAG meets twice a year, gathering about 50 people from 20 governments, 20 businesses, and a handful of OECD secretariats, and formulates proposals to the Working Party 9 on consumption taxes. The WP-9, in turn, reports to the Committee on Fiscal Affairs (CFA), which includes OECD countries' top tax authorities and makes any final decisions, said Battiau, who previously managed tax and regulatory affairs for a European financial services association, which he represented on the TAG.

Claudio Fischer, Zurich-based senior manager for tax policy development for Europe, the Middle East, and Asia at Ernst & Young, said OECD only allowed the business sector to join the discussions on VAT a few years ago, through the TAG. He called this a major improvement that allows input from the real economy.

To resolve the VAT “mess,” Fischer suggested OECD will in the long run opt to publish a model VAT law, similar in ambition to its Model Tax Convention for direct taxes, but Battiau said extensive guidelines similar to the OECD transfer pricing guidelines are a more likely solution.

With a comprehensive solution still distant, multinational companies need to manage their global VAT burden problem now, said Fischer, who until 2010 represented Switzerland on the WP-9.

A Broad-Based Tax

VAT, sometimes called goods and services tax, is a broad-based levy on a product or service's estimated market value, tacked on to total value at each stage of manufacture, creation, or distribution. In a VAT system, each business in the supply chain collects the tax and remits the difference between VAT paid out to suppliers and VAT charged to consumers, who pay the final tax.

By contrast, the United States, OECD's only member without a VAT, uses state-administered sales taxes assessed on the final retail price. OECD frequently urges the United States to adopt a federal VAT to help reduce its huge budget problems.

OECD governments generally allow companies to deduct input tax on supplies. This is supposed to ensure VAT is neutral for companies, whatever their product, distribution chain, and technical means for delivery. But certain VAT-exempt sectors, such as financial, health care, and cultural services, do not get the input deduction, and this leads to complications, OECD said.

Where countries use an invoice-credit method, tax on foreign-supplied services and intangibles is usually collected by the so-called reverse charge mechanism, under which the VAT-registered customer can account for tax on supplies received from foreign providers.

The mechanism is supposed to reduce administrative burdens for companies but rules differ across jurisdictions. Worse, not all jurisdictions have such a mechanism, which in principle forces foreign suppliers to register for VAT purposes and fulfill all VAT obligations in that country, sources said.

A Growing Burden

Fischer said multinational companies' VAT burden is significant and still growing.

France created the world's first VAT about a half century ago and was followed by other European Union countries, but many of the approximately 140 countries that have VAT today adopted it during the past 10 to 15 years. “So it's quite a young tax for much of the world, outside of Europe,” Fischer said.

OECD said value-added taxes now account for 20 percent to 25 percent of government revenues across its member countries.

In the face of budget crunches caused by the global economic crisis, countries with existing value-added taxes have recently been raising their rates and increasing compliance audits, Fischer said.

In theory, VAT should not be a cost for businesses. However, companies have said VAT systems turn them into unpaid tax collectors, a highly cost effective arrangement for governments but not such a great deal for businesses (145 DTR Special Report, 7/30/10). Companies said VAT refunds are sometimes long in coming, while some countries do not refund VAT at all. Some jurisdictions do not compensate companies for VAT they lose when customers do not pay their debts.

An OECD survey of 308 businesses in 2010 found that due to complicated or nonexistent refund procedures, more than 75 percent of businesses are unable to fully recover VAT paid to foreign governments (25 DTR I-1, 2/9/10). The February survey report, based on data collected from 2007 to 2009, noted that many businesses incur VAT in countries where they do not have taxable activity or are not established.

OECD said more than 80 percent of foreign businesses reported annual foreign VAT burden exceeding $10,000, while more than 25 percent reported foreign VAT of $1 million annually.

Growth of Global Trade

Until the late 1990s, the CFA mainly focused on direct taxes, managing such OECD flagship publications as the Model Tax Convention and the Transfer Pricing Guidelines, and setting standards, such as in the area of information exchange.

But as globalization and the internet's growth spurred expansion in international trade, particularly electronic commerce, consumption taxes grew in importance and OECD governments saw the need for some common rules, said Karl-Heinz Haydl, who represents the Business and Industry Advisory Committee (BIAC) to the OECD on the TAG.

OECD's Ottawa Taxation Framework in 1998 established that e-commerce consumption taxes should be assessed in the consumer's jurisdiction, the so-called destination principle, as well as other basic nonbinding principles that underpin most current OECD VAT systems. These include the need for clear, fair, and efficient consumption tax rules to hold down compliance costs for both business and government, to control evasion and avoidance, and the need for tax administrations to keep up with changes in technology.

Two Core Principles

For VAT on international trade in tangible goods, OECD said the destination principle usually works fine, because tax can be collected at the border, along with customs duties. But that does not work for services and intangibles, such as intellectual property rights, because they usually do not pass through any physical borders.

So for the past five years or so, OECD has tried to forge, with mixed results, some common principles aimed at preventing member countries' VAT from stifling international trade in services and intangibles. The organization launched an initiative to develop guidelines for that purpose in 2006 (37 DTR G-1, 2/24/06).

The first draft of the guidelines was essentially a table of contents, to which the CFA has been gradually adding since, drawing on meetings of the TAG, the WP-9, and the CFA, sources said. OECD released a second draft of the guidelines in 2010 (http://www.oecd.org/document/42/0,3746,en_2649_33739_44559914_1_1_1_1,00.html), stressing that they are a work in progress.

Among the CFA's first additions to the guidelines project were two core principles—the neutrality principle that VAT should not be a cost for business, and the destination principle on place of taxation, said Haydl, who is also the Munich-based VAT manager for GE Corporate.

The neutrality principle states that, in most cases, jurisdictions should have mechanisms to allow

businesses to get a refund or credit for VAT levied on transactions between businesses. It says VAT should not be a primary influence on business decisions, such as what legal form to take—branch or subsidiary structure—and similar businesses should be taxed at similar levels within the same jurisdiction. Foreign businesses should neither be penalized nor favored by VAT policies in the jurisdictions where the tax is due.

VAT should not create unreasonable compliance burdens for business, or for tax administrations, according to OECD.

No VAT on Exports

The destination principle, along with the neutrality principle, aims to ensure governments collect the right amount of tax from the right source, OECD said. Sanctioned by the World Trade Organization, the destination principle holds that, in most cases, exports are free of VAT, while imports should be assessed according to rules in the local jurisdiction of consumption.

The idea is that revenue accrues to the jurisdiction of the final consumer.

Fischer said OECD governments debated a long time before finally agreeing on the destination principle for international treatment of VAT. The alternative was the so-called origin principle, under which each jurisdiction tacks on VAT to value created within its own borders. This would have exporting jurisdictions tax exports on the same basis and rate as domestic supplies, while importing jurisdictions would credit against their own VAT for hypothetical tax paid at the importing jurisdiction's own rate.

While the destination principle theoretically allows for geographic neutrality, a key weakness of the origin principle is that final tax would reflect divergent rates added along the production chain, OECD said.

Neutrality Guidelines Published

The CFA in June released the “OECD International VAT/GST Guidelines on Neutrality,” which in six guidelines restated OECD's existing neutrality and destination principles for VAT treatment of international trade.

The 10-page neutrality guidelines are one “building block” in the overall OECD project to develop comprehensive VAT guidelines for international trade, Haydl said. “It's a big stone to lift, a massive project, so we've broken it down that way.”

The new guidelines added some interesting new wrinkles to the existing principles. In comments to OECD, business associations praised the overall project but also expressed some reservations.

OECD has said the guidelines are not “written in stone” and could still be changed despite publication.

Guideline 1 states that VAT itself should not be a burden on business “except where explicitly provided for in legislation.” Guideline 5 says, among other things, that government may choose from a variety of approaches for ensuring businesses do not incur irrecoverable VAT and Guideline 6 offers that, “where specific administrative requirements for foreign businesses are deemed necessary, they should not create a disproportionate or inappropriate compliance burden for the businesses.”

The guidelines say VAT policies should enable companies to know the tax implications of their business decisions.

‘Significant Contribution'

OECD July 22 published a four-page summary of stakeholder comments it received in response to a draft version of the neutrality guidelines it released in December (246 DTR I-3, 12/27/10; http://www.oecd.org/dataoecd/42/9/48432117.pdf). OECD said it received 11 responses—seven from major business associations, three from global advisory firms, and one from an international company. It did not attribute comments to individual organizations but BNA obtained some of the full commentary directly.

The Washington, D.C.-based Tax Executives Institute hailed the new guidelines as a significant contribution to global tax policy that will help protect governments' VAT revenues while reducing double taxation, avoiding unintentional taxation of exempt items as well as unintentional nontaxation of taxable items, and easing compliance.

TEI agreed with Guideline 4, that foreign businesses should not be discriminated against. Businesses affected by discrimination “will incur additional costs and burdens and make decisions to overcome or compensate for the discriminatory treatment; such costs will often be borne by the consumer directly or indirectly,” it said.

Difficulties for Financial Services

Haydl said financial services, because they are VAT exempt in many jurisdictions and also because they employ a branch, rather than a subsidiary, structure, are the “elephant in the room” when it comes to OECD discussions over VAT neutrality and place of taxation.

The stakeholder comments indicated divergent positions on the issue, depending on the sector they represented. Sources said the issue is a highly sensitive one in discussions, noting that EU efforts to debate financial services' VAT exemption have been difficult.

The London-based Investment Management Association (IMA) cited several areas where it said the neutrality guidelines should be tweaked to accommodate financial services. It noted that the 2006 guidelines stated that transactions for many financial services are VAT exempt because the tax base of outputs is difficult to assess. Some health care, education, and culture companies are also exempt due to policy reasons. The IMA argued the neutrality guidelines should explicitly acknowledge that governments also sometimes accord VAT exemptions for financial services in order to accomplish broader policy goals, such as encouraging savings by citizens.

Nevertheless, the association said that, although the destination principle poses problems, it is much preferable to the origin principle, which could encourage companies to locate in low-tax countries, distorting competition.

VAT ‘Sticks' to Banks

The British Bankers' Association (BBA), a group of more than 200 banks and financial companies in 60 countries, also cited problems in applying the neutrality principle to partly exempt sectors, especially financial services.

It said the qualification in Guideline 1—“The burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation”—“renders the basic principle meaningless, allowing states to limit the VAT recovery according to the type of supply or supplier.”

BBA said that, under this guideline, an exempt financial supply in the United Kingdom may become taxable in Germany, while the supply of parking in the United Kingdom is not taxable if made by a local authority. “This qualification is particularly important for UK banks who suffer large amounts of sticking VAT as a result of the exemption of financial services,” it said.

For its part, TEI said it “concurred” with Guideline 1's approach to legislative provisions. “Legislation should ensure that taxable businesses do not unintentionally suffer the cost of the VAT, [and] compliance requirements—such as business costs—should be reasonable and proportionate, especially requirements relating to tax recovery mechanisms including documentation of input tax deductions, or credits in an invoice credit system,” TEI said.

The Question of Branches

Battiau said that for companies established on the basis of subsidiaries, the destination principle usually works fine, because each subsidiary can be treated as a separate legal entity for VAT purposes.

On the other hand, determining place of taxation for financial services companies is challenging because the industry tends be structured in branches rather than subsidiaries. The branches are not separate legal entities.

Battiau gave the example of a large U.S. bank with a U.S. head office and regional branches worldwide, within one legal entity. If the bank acquires an ERP system, the challenge from a VAT standpoint is to determine who the final consumer is—the head office alone or all the branches, and for what part each or only one of them, in which case which one?

“If the rule were to allocate VAT on the basis of actual use, that would result in a nightmare. How are you going to track and prove actual use?” Battiau said.

He said the issue is highly sensitive because jurisdictions want to protect their revenues, while companies want to protect theirs. The tax stakes can be significant. If the place of taxation is London, the VAT rate is the United Kingdom's 20 percent. The United States has no VAT. “That's a heck of a difference. This is what we are dealing with,” Battiau said.

Exemption Creates Complications

Fischer said that because financial services cannot recover VAT input there is “a hidden tax which is in the price and makes the service more expensive.” However, he said, “This is not a cross-border problem in the first instance. It is really something that can be dealt with in every single country.”

Still, Battiau said the industry's exemption adds an extra complication to the place-of-taxation question. Were financial services not VAT exempt, they could recover VAT on a reverse charge basis, “so it would be less of an issue to define which parts of the business are actually receiving the service,” he said.

Battiau said the TAG's work under the CFA is “trying to design a system that makes VAT systems interact in a nondistortive manner. We are trying to achieve agreement among member states for a framework that could allow some exceptions.”

He said the financial services industry is participating “very constructively” in the TAG's efforts. “We're pretty confident that we may come to a reasonably acceptable result, in theory and in practice, without creating additional compliance burden and costs,” he said.

Other Exceptions

Fischer said other exceptions exist for which the destination principle may not be ideal, for example when the destination is one place, and place of consumption is another.

“You could discuss forever if it makes sense to tax a service related to immovable property where the owner of the property is located or should it rather be taxed where the immovable property is,” he said.

Haydl said so-called on-the-spot supplies also create problems for business VAT recovery, such as when a business traveler in a foreign country eats in a restaurant, takes a taxi, and is charged local VAT that then must be recovered from abroad. Various countries have mechanisms to do that, but some do not.

Some countries, based on the reciprocity principle, do not allow a foreign company to recover VAT if the country it comes from does not have a reciprocal arrangement, Haydl said. For example, Poland and some other Eastern European countries that entered the EU in 2004 do not allow U.S. businesses to recover VAT because businesses from those countries are not able to recover U.S. state sales tax, although OECD does not consider the state taxes to be value-added taxes, said Haydl.

The BBA said problems arise in jurisdictions that have implemented VAT/GST but do not fully observe the OECD principles.

For example, although the European Union has implemented the destination principle and accompanying reverse charge rule, the EU's “perception of under-collection of tax has led to measures such as statistical reporting requirements. ... [Consequently], the compliance cost for business is steadily increasing, which is counter to the neutrality principle,” it said.

The IMA noted that some countries do not have reverse charge mechanisms. It said the guidelines should urge implementation of reverse charge rules to minimize the requirement for suppliers to register for VAT in countries where they are not established.

“Within the European Community, the reverse charge for intra-EC supplies fits a need and is relatively simple for business to operate,” it said.

Influence of VATs

Both the TEI and the Brussels-based European Federation of Accountants (Federation des Experts Comptables Europeens, or FEE) expressed doubts regarding Guideline 3's wording on neutrality that “VAT rules should be framed in such a way that they are not the primary influence on business decisions.”

TEI noted that the guidelines also state that a number of factors “can influence business decisions, including financial, commercial, social, environmental and legal factors.” Consequently, it suggested revising Guideline 3 to say that “VAT rules should be framed in such a way that they do not have a significant influence on business decisions,” to improve consistency.

FEE said governments would be unlikely to be able to determine how tax laws influence particular decisions by business.

“We understand that governments should not be encouraged to introduce intentionally VAT rules which are likely to become primary factors of business decisions. This goal could, in our opinion, be better expressed by the wording ... ‘VAT rules should be framed in such a way that they do not inappropriately interfere with business decisions,’ ” the FEE suggested.

TAG to Consider Exceptions

Haydl said the TAG will test services, to see whether they fall under the main rules or whether there is a need for an exception for place of taxation.

The group hopes to keep exceptions to a minimum—because they create additional burdens for both business and government, paperwork and otherwise—to ensure VAT remains neutral, ends up in the right place, and that refunds are made when appropriate, he said.

The meeting will work on developing guidance for governments to implement the neutrality principles as part of OECD's Consumption Tax Guidance Series, as requested by stakeholders, Haydl added.

Model Law Needed

Fischer said OECD is the only international organization working on international guidelines. “Once we have these guidelines that will really be a big step forward,” he added.

He said he thinks OECD will eventually publish a model VAT law, as it has done with the Model Tax Convention.

“It could be a model law that countries can implement, so they would have the same rules, which would take care of all these problems with double taxation and different invoices and different tax returns and so on. I think that would be the most reasonable and realistic outcome,” he said.

He said the World Bank has a model VAT law but that it has not been implemented uniformly. “Something has to be done, because this [VAT mess] is hampering and sometimes blocking international trade,” Fischer said.

Battiau said there has been no formal discussion about a model law in the TAG, although the subject has come up. He thought it more likely the CFA will eventually publish a book of VAT guidelines, as it has done for transfer pricing.

Need for Preparation

Meanwhile, companies cannot afford to wait to prepare for VAT, said Fischer. He said companies are becoming more aware of that and are building up indirect tax departments and hiring specialists, so they are better prepared.

“One of the crucial things is to have a very good internal reporting system, because VAT is linked to every transaction that may take place in a branch of a company somewhere in the world. The centralized tax department must be aware of what's going on,” said Fischer.

An overall VAT strategy is another second very important point, so the company knows how it wants to deal with VAT and what it wants to achieve. Companies need to have a focus and then to implement that throughout the multinational enterprise, he said.

Governments could help by developing standard invoices and implementing electronic filing for VAT declarations and recovery, he said.

CFA decisions must be made by consensus. Sources said the committee faces many difficult questions

and decisions and, consequently, a comprehensive solution to international VAT issues is likely five to 10 years away.

Fischer and Battiau both cited the consensus negotiators' dictum, “Nothing is agreed until everything is agreed.”

BNA August 2011