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10 May 2013

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Re: *International VAT/GST Guidelines Draft Consolidated Version*

Dear Mr. Battiau,

In February 2013, Working Party No. 9 on Consumption Taxes of the Organisation for Economic Co-operation and Development (OECD) released a consultation document setting forth four new draft elements of the *International VAT/GST Guidelines* (the Guidelines). The elements address the core features of VAT systems to which the Guidelines apply and provide a framework for determining the place of taxation for cross-border supplies of services and intangibles. The draft elements have been presented in a single consolidated document that includes previously released guidelines and related commentary to aid readers in understanding the overall scope and structure of the Guidelines (the Draft Consolidated Guidelines). Tax Executives Institute submitted comments on the previously released VAT/GST Neutrality Guidelines on 31 March 2010, and on the related commentary to those guidelines on 26 September 2012, both of which are included in the Draft Consolidated Guidelines. As President of Tax Executive Institute, I am pleased to submit the following comments on the Draft Consolidated Guidelines.

Tax Executives Institute

Tax Executives Institute (TEI) was founded in 1944 to serve the professional needs of in-house tax professionals. Today the organization has 55 chapters in North America, Europe and Asia. In 1999, TEI chartered a chapter in Europe, which today encompasses a cross-section of European and multinational companies. Our 7,000 members represent 3,000 of the largest companies in the United States, Canada, Europe, and Asia. Some of the Institute's members are also actively involved in the OECD Technical Advisory Group (TAG) assisting in the development of the Guidelines.

TEI members are accountants, lawyers and other corporate and business employees responsible for the tax affairs of their employers in an executive, administrative, or managerial capacity. They bring with them a wealth of practical business and technical expertise. As the pre-eminent international association of in-house tax professionals, TEI has a significant interest in promoting tax policy, as well as in the fair and efficient administration of the tax laws, at all levels of government. The Institute espouses organisational values and goals that include integrity, effectiveness and efficiency, and dedication to improving the tax system for the benefit of taxpayers and tax administrators alike.

General Comments on the Draft Consolidated Guidelines – Overall Context

Over the last half-century, the VAT has become one of the most prevalent forms of taxation in the world. Today, more than 150 countries employ VATs that affect nearly four billion people.[1] The tax now raises 20 percent of global tax revenue, significantly exceeding revenues from the corporate income tax and property taxes.[2] This widespread and growing use of VAT has increased the importance of making administration of the tax as efficient and effective as possible. As more countries employ VAT regimes, however, there is greater risk of creating a patchwork of inconsistent rules that could (and often do) result in double taxation or double non-taxation thereby eroding the principle of neutrality, which is critical to a properly functioning international VAT system. TEI commends the OECD and its Working Party No. 9 for their ongoing efforts to develop international VAT guidelines and appreciates this opportunity to comment on the Draft Consolidated Guidelines.

As noted in the Preface to the Draft Consolidated Guidelines, the purpose of the VAT is to tax final consumption with businesses acting as tax collectors for governments. This concept, which is known as the "neutrality principle" is described further in the Preface as follows: "Although they should not, in principle, bear the burden of the tax, businesses inevitably bear compliance costs associated with the collection of the tax from the final consumer and with the remittance to the authorities. Businesses are therefore considered key partners for governments in designing and operating VAT systems."[3] TEI agrees. Businesses strive to comply responsibly with their VAT obligations to ensure proper collection and timely remittance of VAT revenues, and seek efficient administration of VAT by tax authorities. A global VAT framework with clear, simple, and fair rules assists in these efforts and the associated efficiencies will also help boost cross-border trade and investment as well as timely remittance of the related tax revenues.

In addition to the neutrality principle, there has been widespread agreement on the use of the "destination principle" for determining where supplies of internationally traded goods, services, and intangibles should be subject to VAT – *i.e.*, taxing supplies in the jurisdiction of consumption. Despite that consensus, countries have employed varying interpretations of the destination principle, often resulting in double taxation or unintended non-taxation, which

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[1] OECD, *Consumption Tax Trends 2012, VAT/GST and Excise Rates, Trends and Administration Issues* (November 2012), p. 44.

[2] *Id.*

[3] Preface, Draft Consolidated Guidelines, para. 7.

also violates the neutrality principle by placing the burden of the tax on businesses unable to recover VAT on their business inputs. This problem is exacerbated in the many countries that do not provide for a VAT refund scheme to non-resident taxpayers or make the process for claiming those refunds overly burdensome.

In this respect, the Guidelines serve as a beacon of sound tax policy, reinforcing and clarifying core VAT principles through clear guidance for countries when they enact, apply, and revise their VAT systems. We applaud the OECD's outreach to key trade and businesses organizations to assist in the continuing development of the Guidelines by inviting comment in public consultations. TEI encourages the OECD to continue this approach in other forums, such as the OECD Global VAT/GST Forum to enhance and promote dialogue and cooperation on cross-border VAT work.

Specific Comments on the Draft Consolidated Guidelines

Chapter 3 of the Draft Consolidated Guidelines addresses the application of the destination principle to cross-border business-to-business supplies of services and intangibles. Since the share of the global economy attributable to these items continues to expand, the related VAT treatment has similarly become increasingly important to multinational enterprises and governments.

> ***Guideline 3.1:*** *For consumption tax purposes internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption.*

Comment: The Draft Consolidated Guidelines continue to build on two foundational principles adopted by the OECD's Committee on Fiscal Affairs in 2006: (1) neutrality of the global VAT system, and (2) use of the destination principle for determining the jurisdiction where taxation should occur. Guideline 3.1 confirms that, in cross-border trade, the neutrality of the global VAT system is achieved by the application of the destination principle. The explosive growth of transactions involving intangibles and services, as well as increased use of the Internet as a mechanism to deliver those items remotely, creates difficult challenges for determining the jurisdiction of consumption.

Countries have taken different approaches for making that determination, which creates a difficult environment for multinationals supplying services in multiple jurisdictions through complex structures. TEI agrees that the destination principle is a foundational principle for VAT systems, and applauds the efforts of the OECD to establish a clear set of guidelines that encourage a consistent application of that principle. This will help maintain VAT neutrality for business-to-business supplies in the cross-border context.

> ***Guideline 3.2:*** *For business-to-business supplies, the jurisdiction in which the customer is located has the taxing rights over internationally traded services or intangibles.*

Comment: Paragraph 3.6 of the Draft Consolidated Guidelines states that the jurisdiction of the customer's location is an acceptable proxy for the jurisdiction of business use (*i.e.*, the jurisdiction of consumption) and labels that proxy as the "Main Rule" for determining the jurisdiction with the right to tax business-to-business sales of services and

intangibles. TEI agrees that this provides an acceptable proxy for the jurisdiction of consumption in line with the destination principle. Only in exceptional circumstances should the place of taxation vary from the Main Rule, and those limited circumstances are addressed in Section 3.3.2 of the Draft Consolidated Guidelines. Consistent application of this rule also promotes the neutrality principle and helps ensure that business decisions are driven by economic rather than tax considerations when acquiring services and intangibles.

> ***Guideline 3.3:*** *The identity of the customer is normally determined by reference to the business agreement.*

Comment: In order to determine where a customer is located, one must first accurately identify the customer. Guideline 3.3 states that the "business agreement" is the main element for assisting the supplier, the customer, and tax administrations in determining the identity of the parties, the nature of the supply, and their rights and obligations with respect to that supply. Rather than adopting a technical definition for a "business agreement," the Draft Consolidated Guidelines take a more practical approach, allowing for wide application of the concept. This broad approach reflects the reality that not all supplies are made according to lengthy contracts and that the particulars of transactions are often found in other documents or communications including invoices, purchase orders, emails, and even recordings of telephone conversations. TEI agrees with the approach taken in the Draft Consolidated Guidelines because it affords flexibility in identifying the particulars of transactions rather than locking businesses into a single prescribed documentation format that, applied too strictly, could erode the destination and neutrality principles underpinning the Guidelines.

It is also important to determine whether the customer is a business or consumer, as different rules may apply depending on that determination. TEI recommends that a definition be provided in the Draft Consolidated Guidelines for what constitutes a "business"; at a minimum, guidance should be provided to distinguish a "business" from a "consumer" to ensure consistent application of the Guidelines.

> ***Guideline 3.4:*** *When the customer has establishments in more than one jurisdiction, the taxing rights accrue to the jurisdiction(s) where the establishment(s) using the service or intangible is (are) located.*

Comment: While TEI agrees generally with the approach taken in Guideline 3.4, we note that the term "establishment" is undefined. Countries currently employ varying approaches to defining the term, which results in compliance challenges for multinational businesses. TEI urges the OECD to clarify the establishment concept in the Draft Consolidated Guidelines because it is a critical component of the process for identifying which country has the jurisdiction to tax supplies of services and intangibles.

Guideline 3.4 also states that the jurisdiction of consumption should be the place in which the customer establishment uses the service or intangible and clarifies that "use of a service or intangible" refers to use "by a business for the purpose of its business operations." Footnote 29 clarifies that this concept differs from the "use and enjoyment" concept used in many national laws. History has shown that application of the "use and enjoyment" concept in the European Union has led to discrimination and double taxation of businesses with operations there. Given this departure from a commonly applied concept and the importance

of its interpretation in the context of the destination principle, TEI urges Working Party No. 9 to insert the text of footnote 29 into the text of the Draft Consolidated Guidelines to emphasize its importance.

> ***Guideline 3.5:*** *In those cases where the services are used by one or more establishments other than the establishment that entered into the business agreement, the taxing rights are allocated in two steps. In the first step, taxing rights are allocated to the jurisdiction where the customer establishment that enters into the business agreement is located. In the second step, taxing rights are allocated to the jurisdiction where the customer establishment that uses the service or intangible under a recharge arrangement is located.*

Comment: TEI agrees that the "recharge method" outlined in Guideline 3.5 is the best of the three approaches (mentioned below) considered by Working Party No. 9 for addressing the jurisdiction for taxation of supplies made to enterprises with multiple locations. Businesses generally appreciate VAT rules that follow common business practices because it makes compliance efficient. The "recharge method" provides a mechanism for effectively taxing cross-border supplies of services and intangibles that follows existing regulatory and accounting rules. Linking the VAT treatment with these established documentation flows significantly reduces the compliance burden for businesses (both suppliers and customers) and tax authorities.

The introduction to the Draft Consolidated Guidelines notes that Working Party No. 9 has not reached a final decision on the use of the "recharge method" as the recommended method in this area. The two other approaches being considered are: (1) a direct use method, whereby businesses must identify the individual establishments of a purchasing entity that will use the service or intangible at the time of the original purchase; and (2) the head office method, whereby the place of taxation is deemed to be the location of the customer's main office. Neither of these methods would work as well as the "recharge method" for maintaining consistency with the neutrality and destination principles. Further, the direct use method would require documentation that businesses do not currently maintain, as well as constant monitoring of which establishments eventually use the purchased services and intangibles. While straightforward, the head office approach assigns the place of supply for services and intangibles to jurisdictions that do not represent the place of consumption since the head office often acts as the centralized purchaser for an entity with multiple locations.

TEI urges Working Party No. 9 to include only the "recharge method" in the Draft Consolidated Guidelines. For business, it represents the most efficient of the options considered for complying with the destination principle. As important, only this option should be included in the Draft Consolidated Guidelines because offering multiple options will encourage the use of varying approaches by countries, thereby increasing the risk of double taxation and double non-taxation.

The Draft Consolidated Guidelines note in paragraph 3.76 that the taxable amount of the recharge transaction to the establishment of use is presumed to be equal to the price paid by the purchasing establishment to its supplier. In cases where the internal recharge is bundled with an internal expense, such as employee salaries, the Draft Consolidated Guidelines in paragraph 3.79 provide that the amount of the recharge subject to VAT should include only the amount paid by the purchasing establishment to the external seller for the

subject service or intangible (*i.e.*, excluding any amounts attributable to the bundled internal expenses). TEI agrees with this approach because it is consistent with the neutrality principle.

> ***Guideline 3.6:*** *The taxing rights over internationally traded services or intangibles supplied between businesses may be allocated by reference to a proxy other than customer location as laid down in Guidelines 3.2, when both of the following conditions are met:*
>
> *a) The allocation of taxing rights by reference to customer location does not lead to an appropriate result when considered under the following criteria:*
> - *Neutrality*
> - *Efficiency of compliance and administration*
> - *Certainty and simplicity*
> - *Effectiveness*
> - *Fairness*
>
> *b) A proxy other than customer location would lead to a significantly better result when considered under the same criteria.*

Comment: TEI acknowledges that determining the place of business use in a business-to-business supply of services or intangibles is often difficult. In general, the Main Rule utilizes the place where the customer is located as a proxy for identifying the place of business use, and Guidelines 3.4 and 3.5 provide helpful guidance for applying that proxy where a purchasing entity has multiple establishments that will use the purchased services and intangibles. There will, however, be situations where the "Main Rule" does not result in treatment consistent with the destination principle or creates an unreasonable administrative burden. TEI agrees with the approach in Guideline 3.6 permitting use of alternative approaches in limited circumstances.

> ***Guideline 3.7:*** *For internationally traded business-to-business supplies of services and intangibles directly connected with immovable property, the taxing rights may be allocated to the jurisdiction where the immovable property is located.*

Comment: Many jurisdictions have special rules for determining the place of supply for services and intangibles related to immovable property. The Draft Consolidated Guidelines recognize this and provide a specific rule for those transactions. The threshold question is whether the transaction relates to immovable property. TEI recognizes that different jurisdictions have varying views about what constitutes "immovable property" and what is or is not "directly connected with immovable property." The Draft Consolidated Guidelines should elaborate on these threshold questions to create certainty and consistency in the interpretation and application of the International VAT/GST Guidelines and to minimize double taxation and double non-taxation.

Paragraph 3.104 of the Draft Consolidated Guidelines states that the special place of supply rule for services and intangibles directly connected to immovable property should only be used when the "connection with immovable property… [is] at the heart of the supply

and must constitute its predominant characteristic." TEI agrees that deviations from the Main Rule should be rare and that the threshold for triggering this special rule should be high and should apply only where the association between the supply and the immovable property is clear.

Additional Comments on the Draft Consolidated Guidelines

Although Working Party No. 9 did not specifically request comments from stakeholders on the commentary to the VAT/GST Neutrality Guidelines included in the Draft Consolidated Guidelines, we reiterate here a number of the points made in our 26 September 2012 comment letter.

Section 2.4.2 *– Reciprocity*

Comment: While the Draft Consolidated Guidelines recognize the importance of VAT neutrality, the comments on reciprocity in Section 2.4.2 erode this foundational principle. Through the concept of reciprocity, some jurisdictions limit the ability of foreign businesses to obtain a refund of VAT by only allowing a refund if the country in which they are established provides similar refund options. The Draft Consolidated Guidelines fail to condemn the use of reciprocity to restrict refunds and seek only to limit the conditions under which jurisdictions should apply those restrictions. Reciprocity provisions violate the neutrality principle, making VAT a cost for foreign businesses. TEI believes the Draft Consolidated Guidelines should reject the use of reciprocity in this fashion and require the refund of VAT to foreign businesses as a means of ensuring neutrality.

Section 2.4.3 *– Groups of Countries*

Comment: Section 2.4.3 of the Draft Consolidated Guidelines would permit differences in the treatment of transactions occurring within a group of countries bound by a common legal framework (*e.g.*, the European Union) and those between a member country within that group and a country outside the group. Having different rules applicable to the same type of transaction simply because a service is supplied (a) within the EU on the one hand, and (b) between an EU and a non-EU country on the other, violates the neutrality principle and places an unnecessary burden on cross-border commerce. Cross-border VAT neutrality is best achieved by standards that do not differentiate between countries bound by a common legal framework and other (non-member) countries. TEI favors additional language in the Draft Consolidated Guidelines strongly asserting the need to harmonize international VAT rules. In addition, TEI recommends the OECD clarify that section 2.4.3 should not be read as excluding groups of countries bound by a common legal framework from the application of the Draft Consolidated Guidelines.

> ***Guideline 2.1:*** *The burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation.*

Comment: The Draft Consolidated Guidelines provide that the words "except where explicitly provided" used in Guideline 2.1 mean that countries may legitimately place a VAT burden on business for specific policy reasons, including "legislation that disallows input tax recovery where explicit administrative obligations are not met." While TEI agrees some administrative measures are necessary to prevent tax fraud, we urge jurisdictions to be

judicious when applying this rule because excessive administrative burdens inevitably saddle businesses with unrecoverable VAT in contravention of the neutrality principle. Thus, TEI welcomes the language in the commentary on Guideline 2.1 (paragraph 2.39 of the Draft Consolidated Guidelines), stating that "when governments do impose a VAT burden on businesses … legislation that so provides should be clear and transparent and should keep compliance costs to a minimum."

> ***Guideline 2.2:*** *Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation.*

Comment: TEI agrees and appreciates the clarification made by separating the concepts of "businesses in similar situations" and "similar transactions" in the related commentary. Similar business transactions should be treated equally and the means of delivery of the same (or substantially the same) items should not affect the level of tax applied. The examples in the paragraphs 2.46 and 2.47 of the Draft Consolidated Guidelines help shed needed light on the application of this Guideline 2.2.

> ***Guideline 2.3:*** *VAT rules should be framed in such a way that they are not the primary influence on business decisions.*

Comment: TEI agrees. Ideally, business decisions should be based on commercial drivers rather than tax considerations. VAT rules, however, will likely continue to be a factor when making those decisions.

Presently, a number of countries have (1) unjustifiably delayed the payment of undisputed VAT refund claims for years and (2) erected increasingly high administrative hurdles to substantiate VAT exemptions and zero rating of export sales. These practices are fundamentally at odds with the neutrality principle and deprive businesses of the working capital needed to fund ongoing operations. As a result, businesses alter their supply chains or otherwise alter decisions. We urge Working Party No. 9 to include an example in the commentary to Guideline 2.3, referring to these practices and their inconsistency with the neutrality principle.

Some non-OECD countries use the same registration number for VAT and corporate income taxes, which causes local tax authorities to presume that foreign businesses have a permanent establishment in the country for income tax purposes. The level of in-country activity necessary to trigger VAT registration varies significantly from the activity that may create a permanent establishment. The additional cost to businesses to either remit corporate income tax to jurisdictions in which they have no permanent establishment or challenge the assertion of a permanent establishment in court causes some businesses to alter the way in which they structure their operations. This result is inconsistent with Guideline 2.3. TEI urges Working Party No. 9 to add language to the Draft Consolidated Guidelines highlighting the differences between the permanent establishment concept for corporate income taxes and the requirements to obtain a VAT number in a jurisdiction, noting that obtaining a VAT number does not, by itself, create a permanent establishment.

Guideline 2.4: *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.*

Comment: TEI agrees. Discriminatory taxation creates a barrier to free trade that undermines and distorts competition and limits consumer choice. The additional costs of discriminatory taxation force businesses to adjust their operations to counteract the discriminatory treatment. For example, affected businesses may limit sourcing from jurisdictions when the VAT from that jurisdiction cannot be recovered, thereby increasing their costs. These costs will ultimately be borne by the consumer.

In concert with Guideline 2.2, which calls for similar levels of taxation for businesses in similar situations carrying out similar transactions, similar levels of taxation should apply whether services are acquired abroad or on the domestic market. This is especially important when the country of the supplier has a broad interpretation of the use and enjoyment rule for determining the place of supply for services, without providing any method for foreign businesses to recover VAT. Treating domestic businesses differently from foreign businesses breaches the neutrality principle and distorts competition.

Unrecoverable VAT can also occur when the place of supply rules differ between countries for supplies of intangibles. Jurisdictions should be reminded that inconsistent definitions in this area disrupt the free flow of international commerce. TEI appreciates the work done by Working Group No. 9, especially on Guideline 3.4, to provide well-constructed guidelines that should lead countries to a consistent framework for identifying the place of supply for these transactions.

Guideline 2.5: *To ensure foreign businesses do not incur irrecoverable VAT, governments may choose from a number of approaches.*

Comment: TEI agrees as long as the approach — or combination of approaches — selected by a country does not result in the creation of irrecoverable VAT costs for business, or create an unreasonable compliance burden. The neutrality principle minimizes the situations in which VAT becomes a cost of business and recognizes that unreasonable administrative burdens may have the same effect. It is therefore important to ensure that the approach taken by a jurisdiction does not damage the neutrality of VAT by treating differently supplies by foreign businesses having similar transactions to those of local businesses or creating delays in the VAT refund process for foreign businesses in excess of those applicable to local businesses. Where a government decides as a policy matter to make VAT irrecoverable, the rules should be narrow, clearly defined in legislation or regulations, and nondiscriminatory.

Guideline 2.6: *Where specific administrative requirements for foreign businesses are deemed necessary, they should not create a disproportionate or inappropriate compliance burden for the businesses.*

Comment: In line with the Guidelines for Good Tax Administration,[4] TEI believes that this should be a guiding principle for *all* forms of taxation — whether consumption, income, or excise tax. Thus, administrative requirements should never be disproportionate to the tax levied, nor should they impose inappropriate or discriminatory burdens. TEI acknowledges, however, that in dealing with foreign businesses with no "legal" presence in a jurisdiction, there is an element of risk for tax administrators and measures that may be necessary to protect against VAT fraud or tax avoidance.

TEI urges governments to heed this guidance to ensure that the compliance burdens faced by foreign businesses do not impose a cost that would cause a business to avoid operating in the jurisdiction (*i.e.*, the administrative burden should not influence the business decision). More efficient administrative cooperation between tax authorities could mitigate the fraud risk without increasing the compliance burden imposed on businesses when they act as collectors of the tax.

Conclusion

TEI applauds the excellent work by the OECD on VAT/GST in the last few years and for involving business stakeholders in the TAG process and other initiatives leading to the development of these guidelines. Cooperation between business and governments on an international level is vital to ensuring the operation of a functioning VAT/GST system.

TEI's comments on the Draft Consolidated Guidelines were prepared by the Institute's European Indirect Tax Committee, whose chair is Siegert Slagman. If you have any questions about TEI's comments, please contact Mr. Slagman at +41 (0) 582 426 513 Siegert.Slagman@pmi.com, or Daniel B. De Jong or the Institute's legal staff at +1 202 638 5601 or ddejong@tei.org.

Respectfully submitted,
Tax Executives Institute

Carita R. Twinem
International President

[4] GAP001 Principles of Good Tax Administration – Practice Note (approved in 2001 by the OECD Forum on Tax Administration).