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ELI J. DICKER
Chief Tax Counsel

26 September 2012

Mr. Stéphane Buydens
VAT Policy Advisor
Consumption Taxes Unit
Organisation for Economic Co-operation and Development
2, Rue Andre Pascal 75775
Paris, Cedex 16
France

By email: vat@oecd.org

Re: *Draft Commentary on the International VAT/GST Neutrality Guidelines*

Dear Mr. Buydens:

On 26 June 2012, Working Party 9 on Consumption Taxes of the Organisation for Economic Co-operation and Development (OECD) released a consultation document setting forth its *Draft Commentary on the International VAT/GST Neutrality Guidelines: Achieving Neutrality in Practice* (the Draft Commentary). This Draft Commentary is meant to complement the International VAT/GST Neutrality Guidelines approved by the Committee on Fiscal Affairs of the OECD in July 2011 (the VAT Neutrality Guidelines). Tax Executives Institute submitted comments on the VAT Neutrality Guidelines on 31 March 2010. As President of Tax Executive Institute, I am pleased to submit the following comments on the Draft Commentary.

Tax Executives Institute

Tax Executives Institute (TEI) was founded in 1944 to serve the professional needs of in-house tax professionals. Today the organisation has 55 chapters in North America, Europe, and Asia. As the preeminent international association of business tax professionals, TEI has a significant interest in promoting sound tax policy, as well as in the fair and efficient administration of the tax laws, at all levels of government. Our 7,000 members represent 3,000 of the largest companies in Europe, the United States, Canada, and Asia.

In 1999, TEI chartered a chapter in Europe, which today encompasses a cross-section of European and multinational companies. 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. 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 Commentary

Viewed as an economically neutral and transparent tool for raising government revenue, VATs have been adopted around the world. In the late 1960s, fewer than 10 countries employed a VAT. Today, that number is more than 150, including all but one of the OECD countries. The worldwide economic crisis has placed increased attention on the tax, in part because "[r]aising the standard VAT rate has often been considered as the easiest way to increase revenues from the tax, particularly at a time when many governments are seeking ways to address large fiscal deficits."[1] The higher the VAT rate, however, the more important it is to get the tax right and, in particular, to ensure the neutrality of VAT systems internationally. TEI commends the OECD and its Working Party 9 for their ongoing efforts to develop international VAT guidelines and appreciates this opportunity to comment on the *Draft Commentary on International VAT/GST Neutrality Guidelines: Achieving Neutrality in Practice* (Draft Commentary).

VAT is a transaction-based tax that aims to tax final consumption. The fundamental principle of the VAT is that it is borne by the final consumer rather than any of the intermediaries in the supply chain. Thus, to the extent businesses act as the tax collector on behalf of governments (rather than as a consumer), neutrality is critical. Recent actions by governments undermine this foundational principle. For example, a number of countries in Europe have delayed the refund of VAT overpayments, depriving businesses of the working capital they need to fund their ongoing operations.[2] Additionally, certain countries have created high administrative hurdles to substantiating VAT exemptions and securing zero-rating of export sales.[3] These actions highlight the way in which the OECD's VAT guidance generally, and the VAT Neutrality Guidelines in particular, can advance sound tax policy.

1. **Principles of Good Tax Administration**

TEI welcomes the reference in the Draft Commentary to the Principles of Good Tax Administration approved in 2001 by the OECD Forum on Tax Administration[4] and the express encouragement for governments to apply these principles in practice. Adherence to the eight criteria specified in the Principles is particularly important in respect of the VAT where business acts as tax collector. As explained in Paragraph 4 of the Principles of Good Tax Administration, "[v]oluntary compliance is promoted not only by awareness of rights

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[1] Jeffrey Owens, *Improving performance of VAT systems*, 3 World Commerce Review 8 (September 2011).

[2] *See e.g., Commission v. Spain*, C-16/95 (14 December 1995); *Commission v. Italy*, C-287/91 (3 June 1992).

[3] For example, recent changes to Germany's law on documentation necessary to substantiate export sales of goods increase costs and create new risks for legitimate business and undermine the application of the zero-rating provisions for intra-EU supplies. *See* Letter from Tax Executives Institute to Mr. Donato Raponi, Directorate-General for Taxation and Customs Union, European Commission (7 March 2012), *available at* www.tei.org/news/Documents/TEI-Meeting-Gelangensbestatigung.pdf. In addition, governments have broadened their interpretation of the use and enjoyment rule for services, increasing the chances that businesses will be taxable in multiple jurisdictions on a single supply of a service.

[4] GAP001 Principles of Good Tax Administration – Practice Note.

and expectations for a fair and efficient treatment but also by clear, simple and user-friendly systems and procedures."

2. Reciprocity

While the Draft Commentary emphasizes the importance of VAT neutrality, the reciprocity discussion in Section 1.4 chips away at it. Through the concept of reciprocity, some Member countries only provide foreign businesses with the ability to obtain a refund of VAT if the country in which they are established provides similar refund options. Regrettably, the Draft Commentary in Section 1.4 fails to condemn the use of retaliatory reciprocity provisions, seeking only to limit the conditions under which Member countries should apply them. There can be no doubt that reciprocity provisions violate the principle of neutrality by converting VAT into a cost for foreign businesses, creating distortions in the international VAT system. TEI recommends that the Draft Commentary be revised to reject the use of reciprocity as violating the neutrality principle and endorse the refund of VAT to foreign businesses as a required principle to achieve neutrality.

3. Groups of Countries

Section 1.5 of the Draft Commentary would permit different treatment for transactions occurring within a group of countries bound by a common legal framework (*e.g.*, the European Union) and those occurring between a member country within that group and a country outside the group. These differences would be allowed as long as the treatment of transactions with non-member countries complies with the VAT Neutrality Guidelines, whose aim is to promote rules that ensure VAT neutrality internationally. That goal, of course, is best achieved by having standards that do not differentiate between groups of countries bound by a common legal framework and other (non-member) countries. Thus, TEI encourages the OECD to clarify that Section 1.5 should not be read as excluding groups of countries bound by a common legal framework from the application of the VAT Neutrality Guidelines.

Specific Comments on the Guidelines and the Draft Commentary

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

Comments: The Draft Commentary in Paragraph 17 states that "Guideline 1 is not intended to interfere with the sovereignty of jurisdictions to apply rules for limiting or blocking the right to deduct input VAT." While TEI accepts the core sovereignty of Member countries, we recommend that the Draft Commentary urge restraint since excessive legislation placing the burden of VAT on taxable businesses will erode the neutrality principle and create market distortions.

The VAT Neutrality Guidelines explain in Paragraph 16 that the words "except where explicitly provided" used in Guideline 1were added to permit countries to place a VAT burden on business for specific policy reasons in limited circumstances. Paragraph 19 of the Draft Commentary states 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." TEI agrees with these statements, which comport with the OECD's

Principles of Good Tax Administration. VAT legislation should ensure that taxable businesses do not unintentionally suffer the cost of the VAT and, further, should always treat domestic and foreign businesses equally. The administrative requirements — especially requirements relating to tax recovery mechanisms including documentation requirements for input tax deductions, credits (in an invoice-credit system), and zero-rated supplies — should be reasonable and proportionate.

Paragraph 18 of the Draft Commentary clarifies the meaning of the phrase "except where explicitly provided for in legislation" by including a number of examples of common national legislation such as exempt transactions, transactions for a non-business use, input VAT restrictions intended to achieve specific national policy objectives, and where explicit administrative obligations are not met (*e.g.*, evidence and documentation to substantiate eligibility for zero-rating). TEI recommends the Draft Commentary be expanded to address other transactions that fall outside the scope of the VAT, such as transactions for no consideration. For example, when a business gives out free samples as part of its marketing efforts, there should be no restriction on the ability to deduct related input VAT.

TEI also urges the OECD to clarify the terms "taxable business" and "fully taxable business" in Guideline 1 and the Draft Commentary. While the text of Guideline 1 makes reference to a "taxable" business, Paragraph 14 of the Draft Commentary uses the term "fully taxable" business. A "fully taxable" business apparently means one that is wholly involved in making taxable supplies, whereas a "taxable" business refers to one that is merely VAT registered in a jurisdiction. The similar but non-co-extensive definitions could create confusion, especially for businesses in countries where these terms are not commonly used. TEI suggests that the Draft Commentary specify that the terms "taxable business" and "fully taxable business" refer to the activities of a business making taxable supplies. Alternatively, the word "taxable" could be removed from Guideline 1 since its use there seems unnecessary.

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

Comment: TEI supports the separation of the concepts of "businesses in similar situations" and "similar transactions" in the Draft Commentary. Businesses carrying out similar 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 Draft Commentary help shed needed light on the application of this Guideline 2.

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

Comment: Ideally, business operating decisions should be based on commercial drivers rather than tax considerations. Undoubtedly, however, VAT rules will continue to be a factor in making those decisions. Guideline 3 promotes the view that VAT rules should not become the *primary* driver for those decisions, and TEI agrees.

The VAT rules covered by Guideline 3 go beyond legislation and regulations. Paragraph 19 of the VAT Neutrality Guidelines provides that "VAT considerations include the amount of tax ultimately paid to tax administrations, the compliance burdens related to the collection, payment or refund of the tax such as filing of tax returns, maintaining adequate

book-keeping and the financial costs related to the cash-flow impact of the VAT system." Business enterprises in many Member counties have experienced unjustifiable delays in the payment of VAT refund claims, which have caused them to alter the structure of their supply chains or otherwise change business decisions. We urge the OECD to include an example in the commentary to Guideline 3 (similar to those provided in Guideline 2) highlighting the inconsistency of this practice with the VAT Neutrality Guidelines.

Furthermore, consistent with the Principles of Good Tax Administration, Member countries should provide adequate time for businesses to implement VAT rule and rate changes into their business operating environments. All too often, for example, VAT rates are changed with effective dates that make it virtually impossible to timely update business-wide ERP or other systems and change the pricing of goods and services to implement the change. As a result, businesses are forced to bear the differential in VAT rate increases as an irrecoverable cost until they complete the necessary systems changes; this approach clearly contravenes the neutrality principle. TEI urges the OECD to modify the Draft Commentary to discuss the need for substantial advance notice of changes to VAT rules and rates so that businesses may have adequate time to revise, test, and implement changes.

> ***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.*

Comment: TEI agrees. Discriminatory levels of taxation create a clear barrier to free trade that undermines and distorts competition and limits consumer choice. The additional costs often force businesses to adjust their operations in order to compensate for the effects of discriminatory treatment. For example, affected businesses may limit sourcing from jurisdictions where VAT cannot be recovered, thereby increasing costs that will ultimately be borne by the consumer.

In concert with Guideline 2, which calls for similar levels of taxation for businesses in similar situations carrying out similar transactions, Guideline 4 supports imposition of similar levels of taxation without regard to whether services are acquired abroad or on the domestic market.[5] Unrecoverable VAT can also occur when the place of supply rules for supplies of intangibles (including services) differ between countries. To ensure that the Draft Commentary does not undermine the VAT Neutrality Guidelines and International VAT/GST Guidelines, Member countries should be reminded that inconsistent definitions for the place of supply for services and intangibles disrupt the free flow of international commerce and can result in both non- and double taxation.

Additionally, businesses operating internationally must often register for VAT purposes in numerous countries to claim refunds of overpaid VAT on sales to customers located there. Many countries require the creation of a registered address in the country in order to become VAT registered and thus eligible to apply for a VAT refund. In some cases,

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[5] This becomes 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 and does not provide any method for foreign businesses to recover this VAT. *See* Paragraph 7, OECD International VAT/GST Guidelines (approved February 2006) (discussing compliance burdens and distortions of competition that occur when domestic businesses are treated differently than foreign businesses).

such a requirement will result in the creation of a permanent establishment (PE) for corporate income tax purposes, even though simply having customers located in a jurisdiction, without more, would generally not create a PE. Assertion by Member countries of PE status in these circumstances has increased recently. Using VAT registration to distend the traditional PE rules erects a significant barrier to achieving VAT neutrality since it raises the cost to businesses of obtaining refunds to which they are entitled.

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

Comment: Paragraph 43 of the Draft Commentary explains that countries have adopted the following approaches to avoid irrecoverable VAT in cross-border transactions:

- Making supplies free of VAT;
- Allowing foreign businesses to obtain a refund through a specific regime;
- Allowing foreign businesses to obtain a refund through local VAT registration;
- Shifting responsibility to locally registered suppliers/customers; and
- Granting purchase exemption certificates.

So long as the approach — or combination of approaches — selected by a country does not result in the creation of irrecoverable VAT costs for business, and does not create an unreasonable compliance burden, TEI agrees. The neutrality principle is aimed at minimizing situations in which VAT becomes a cost of business, and also recognizes that unreasonable administrative burdens have the same effect by placing an additional cost on businesses in the supply chain. Thus, the approach taken by a jurisdiction should not undermine the neutrality of VAT by treating differently those supplies made by foreign businesses having transactions similar to those of local businesses or creating delays in the VAT refund process when compared to local businesses. Where a government decides as a policy matter to make the tax irrecoverable, the rules should be narrow in scope, clearly defined in the legislation, and nondiscriminatory in accordance with Guideline 1.

> ***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.*

Comment: Consistent with the Principles of Good Tax Administration, Guideline 6 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. That said, in dealing with foreign businesses with no "legal" presence in a jurisdiction, there may be an element of risk for tax administrations justifying measures to protect against VAT fraud or tax avoidance. TEI endorses the point made in Paragraph 49 of the Draft Commentary that full advantage should be taken by tax authorities of available instruments that support exchange of information and mutual assistance between tax authorities. If these instruments are insufficient, specific additional compliance requirements should be sought for foreign businesses, so long as these requirements are not disproportionate and do not contravene the principles espoused in Paragraphs 52 through 54 of the Draft Commentary.

Paragraph 34 of the VAT Neutrality Guidelines properly acknowledges that "an appropriate balance is needed between the perceived benefits of a specific requirement or combination of requirements and the need to prevent unjustified discrimination. In other words, specific rules applicable to foreign businesses should not result in a disguised form of discrimination." Paragraph 45 of the Draft Commentary complements that statement, noting that "[m]easures taken by a government to protect its tax base may therefore need to be balanced with the objective of keeping compliance and administration costs as low as possible." TEI urges the OECD to caution Member countries and other jurisdictions following the Draft Commentary 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 business decisions).

Conclusion

TEI's comments on the Draft Commentary developed by Working Party 9 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 or Siegert.Slagman@pmi.com, or Daniel B. De Jong of the Institute's legal staff at +1 202 638 5601 or ddejong@tei.org.

Respectfully submitted,

Tax Executives Institute

Carita Twinem
International President