International Chamber of Commerce
*The world business organization*

# Policy Statement

# Deficiencies in Value Added Tax (VAT) systems

*Prepared by the Task Force on Indirect Tax Systems*

## Introduction

Since the 1960s, the contribution of general consumption taxes to the tax revenues of the OECD Member States has grown from about 12% to 18%. With the exception of the USA, all OECD Member States – and many non-OECD countries – apply a VAT type consumption tax, levied throughout the production and distribtion chain of goods and services. Mobility and globalization have led to an increase of cross-border transactions of goods and services. As a result, deficiencies in national consumption tax systems have become major obstacles for enterprises engaged in international business and may lead to double or non-taxation.

Through this statement on deficiencies in VAT systems, ICC wants to emphasize the need for improving national VAT systems in order to abolish the obstacles caused by deficiencies in these systems. The last paragraph of the paper includes a summary and recommendations. The basic principles of consumption taxes are explained in the Annex to this paper.

## Deficiencies in VAT systems

The following deviations from the standard VAT principles (as described in the Annex) may lead to deficiencies.

At the national level:

- Jurisdictions that apply different rules for goods and services with regards to the taxable event. Whereas VAT on the supply of goods is based upon accrued sales, VAT on services is based upon receipt of payment for the services. This may give rise to confusion as to the timing of charging output VAT and deducting input VAT.

- Jurisdictions that do not – or only under specific conditions – provide for a reduction of the tax base if cash refunds (rebates) are granted to the customer and/or do not provide for a reduction in case of uncollected receivables.

- Jurisdictions that do not allow excess input VAT (net credit input VAT) to be (immediately) refunded to the taxable person. This may occur when excess input VAT

(a) will not be refunded, or only if special conditions are met, or (b) is carried forward for a specific or an indefinite period of time to be deducted from future output VAT.

- Jurisdictions that do not allow deduction of input VAT related to fixed assets used for taxable activities, thus creating double taxation.

- Jurisdictions that do not allow deduction of input VAT according to a pro rata rule, where input VAT is related to mixed business activities (taxable and exempt activities), thus creating double taxation.

At the international level:

- Jurisdictions that do not allow refund of input VAT paid by a foreign taxable person – even not under a reciprocity condition. This is in conflict with the principle of external neutrality.

- Jurisdictions that require the use of documents in the language of the country of refund, thus making the reclaiming of foreign input VAT more difficult than envisaged in the VAT system.

- Jurisdictions that apply different definitions of goods and services, which – in combination with mismatches in the place of taxation – may lead to double or non-taxation. This issue will be elaborated below.

## Goods and services

As explained above, VAT is a general consumption tax on the supply of goods and services made (by a taxable person) for consideration within the territory of a jurisdiction and on the importation of goods. The supply of goods is generally defined as the transfer of the right, as owner, to dispose of tangible property. The supply of services is generally defined as any transaction that does not constitute a supply of goods.

Mismatches occur if there are differences in the definition of goods and services and in the use of the rules for the place of supply of goods and services.[1] Such inconsistencies lead to unintentional non-taxation or double taxation and have a negative effect on global trade. One could argue that non-taxation does not lead to an economic problem if supplies of goods and services take place between VAT liable persons.[2] The mismatch, however, frustrates the formal rules for cross-border transactions between taxable persons and, even more so, if the customer uses the goods and services for exempt activities, non-taxation frustrates the

[1] Mismatches in the place of supply for VAT/GST type of taxes were discussed in Seminar D during the International Fiscal Association (IFA) Congress, Oslo, 1992. The outline paper by Michel Aujean (chairman of the seminar) has been an important source for this ICC statement.

[2] The VAT/GST "triangle" between the taxable supplier, the taxable customer and the fisc leads to nil VAT/GST revenues for the fisc and to nil VAT/GST burden for the taxable traders involved.

principle that input-VAT should bear upon that customer. Double taxation gives rise to problems for both taxable customers and exempt customers. If the buyer of the goods or the services is a taxable person for VAT who has the right to deduct input-VAT, recovery of tax charged by another jurisdiction (due to a mismatch) can be complex and even impossible. If the customer has no (full) right to deduct input-VAT, because his supplies are partially or fully exempt, the customer will suffer the burden of double taxation.

*Asymmetrical distinction between goods and services*

In general, the supply of services is defined as any transaction that does not constitute a supply of goods. However, if two jurisdictions apply an asymmetrical distinction between goods and services, this may lead to non-taxation or double taxation. E.g. if country A defines a specific cross-border transaction as a supply of goods and another country B defines the same transaction as a supply of services, the transaction will not be subject to any VAT if country B applies the main rule for the place of service. According to that rule the service should be taxable in country A, but that country applies a zero rate VAT on (what that country defines as) a supply of goods. If the same transaction is done by a supplier in country B to a customer in country A, the transaction will be subject to VAT in B (main rule) and also in A (import or intra community acquisition).

Technical progress and market innovation lead to transactions that cannot always be clearly identified as the supply of goods or the supply of services in the traditional way. Problems arise especially if a mixture of goods and services, e.g. hardware and software subscription, are bundled in one transaction.

Some jurisdictions try to solve such problems by not making a distinction between goods and services (applying a general rule for the place of supply), whereas other countries use three categories of taxable transactions (adding intangibles as a separate category). As mobility in the supply of services increases and tends to spread world wide, inconsistencies in VAT treatment will continue and even grow.

*Conflicting rules for the place of taxation*

In the case of goods dispatched or transported cross-border, the place of supply is where the goods are at the time when dispatch or transport to the customer begins. In order to comply with the country of destination principle, exportation of goods (or, in case of cross-border supplies of goods within the EU, the 'intra community supply') is subject to zero rate VAT (which is the same as being exempt with the right for the supplier to deduct input VAT). The customer of the goods will be subject to VAT in the country of importation (or, in case of cross-border supplies of goods within the EU, in the Member State where the 'intra community acquisition' takes place). This tax collection system results in practice that goods for the most part are taxed in the jurisdiction where they are consumed.

Many countries introduced VAT at a time when services involved the physical presence of the

supplier. In these countries, the main rule is that services are taxable at the place (in the jurisdiction) of the supplier of the service. Meanwhile, there is a growing number of exceptions to this main rule which reflect developments in business practice. The substantial growth of cross-border services and the fast development of electronic commerce raise the question whether the present rules for taxing services under VAT need to be adapted in order to comply with the country of destination principle. As regards cross-border services, there is less assurance that they will be taxed where consumed than in the case of cross-border supplied goods, although more recently introduced VAT systems apply the main rule that the place of supply of the service is where the customer is resident or established.

Differences in the place of service rules in various jurisdictions may lead to situations where the cross-border service is either not taxed or taxed in both the country of the supplier and the country of the customer. Even within the EU, where the Sixth VAT Directive has set harmonized rules for the place of service, Member States have not implemented these rules identically in their national VAT legislation. The judicial interpretation of national legislation by national courts and by the European Court of Justice may lead to consequences that are not foreseen or intended by legislators.

## Summary and recommendations

A general consumption tax should lead to a recognizable, strictly proportional and identical consumption tax burden on similar goods and services, irrespective of the length of the production and distribution or services chain (internal neutrality) and, in the case of a cross-border trade and services, irrespective of the origin of the goods and services (external neutrality).

The credit-invoice VAT system, as applied by the great majority of OECD Member States, is a multi-stage non-cumulative consumption tax that can meet the above objectives. However, certain deficiencies at the national or international level may frustrate the basic VAT principle of neutrality and lead to double or non-taxation.

The following recommendations are made in order to avoid deficiencies at national and international level.

1. The problems of international mismatches caused by asymmetrical definitions of goods and services and conflicting rules for the place of taxation[3] should be solved by applying internationally identical definitions of goods and services and by applying identical rules

[3] An example may illustrate this. A supply and installation contract (which could not be split) may be treated as a supply of goods or a supply of services or a mixture of both. The place of supply is usually where the installation takes place. If a supplier in country A is installing in country B, he performs a VAT liable supply in country B. A disctinction between a supply of goods or services could be important for the obligation of registering for VAT. Especially in EU Member States a reverse charge mechnism could be used if the contract is treated as leading to a supply of services and therefore a VAT registration could be avoided.

for the place (jurisdiction) where the supplies of goods and services are taxed for VAT purposes; this could possibly be accomplished by a network of bilateral agreements between jurisdictions, based upon a "Model VAT/GST Convention" comparable with the OECD Model Tax Convention on Income and Capital.

2. A reduction of the tax base should be applied if cash refunds (rebates) are granted to the customer;

3. A reduction of the tax base should be given to the supplier in case of uncollected receivables; the problem that input VAT has been claimed by the (insolvent) VAT-liable customer should be solved between the fiscal authorities of the customer and the customer exclusively;

4. Excess input VAT (net credit input VAT) should be refunded forthwith to the taxable person or immediately offset (deduction against other taxes should be allowed); any actions by the fiscal authorities to delay the refund should not be allowed, unless there are serious indications of fraud;

5. Input VAT related to fixed assets used for (or in so far as used for) taxable activities should be deductible or refunded;

6. Where input VAT is related to mixed business activities (taxable and exempt activities), deduction of input VAT should be allowed according to a pro rata rule;

7. Input VAT paid by a foreign taxable person should be refundable in the same circumstances and on the same conditions as for domestic taxable persons; documents used for reclaiming foreign input VAT should not be exclusively in the language of the country of refund;

8. Within the EU, the present system of reclaiming input VAT in another Member State should be replaced by deducting the foreign input VAT in the domestic VAT return of the reclaiming entrepreneur, followed by clearing between the Member States involved; as long as the rules for deductibility of input VAT have not been harmonized, the deductibility rules of the Member State where the input VAT has been paid should be determinative.[4]

[4] As long as harmonisation has not been achieved, a compromise could be found by appointing a domestic VAT office for filing the request for refund of foreign input VAT paid to suppliers in other Member States.

# ANNEX

## Principles of consumption taxes

The three main categories of taxation are taxes on income, capital and consumption. Within the last category, distinction is made between general consumption tax and specific consumption taxes (like excise duties or customs duties on specific products). Consumption taxes are referred to as 'indirect taxes', as the taxable person collects the tax from the person who economically bears (and is meant to bear) the tax burden.

Since the 1960s, the role of general consumption taxation has grown within the OECD Member States.[5]

| | General Consumption Tax Revenues as % of GDP | | General Consumption Tax Revenues as % of Total Tax Revenues | |
|---|---|---|---|---|
| | *1965* | *1998* | *1965* | *1998* |
| OECD | 3.3 | 6.6 | 11.9 | 17.9 |
| America | 2.9 | 3.5 | 11.3 | 13.7 |
| Pacific | 1.2 | 4.4 | 5.0 | 15.0 |
| Europe | 3.7 | 7.4 | 13.0 | 19.1 |
| EU-15 | 3.8 | 7.3 | 13.3 | 17.9 |

Figures per country show a great variety. In 1999 consumption tax revenues as % of GDP varied between 2.2% in the USA and 9.8% in Denmark, whereas consumption tax revenues as % of total tax revenues varied between 7.6% in the USA and 30% in Turkey. Also since the 1960s, the Value Added Tax system has become the preferred system for general consumption taxation.[6]

At the same time, mobility and globalization have lead to an increase of cross-border transactions of goods and services, both business-to-business and business-to-consumer. Since the introduction of the internet, the phenomenon of transactions by electronic means has set a new dimension for cross-border electronic commerce. As a result of these developments, cross-border effects of consumption taxation have become more important.

This report focuses on deficiencies in VAT systems as they are currently applied in tax jurisdictions. Such deficiencies can only be identified if there is a standard to compare with. As there is no national (or sub-national or supra-national) VAT system that can be referred to as "the" standard, we hereinafter formulate a standard VAT, without using any existing VAT system as the standard for comparison.

[5] Source: Revenue Statistics OECD Member States, 1999.

[6] 29 of the 30 OECD Member States apply a VAT type consumption tax (sometimes referred to as GST, i.e. Goods and Services Tax).

## A standard VAT

For the purpose of this study we focus upon the VAT system that is used to levy a general tax on the consumption of goods and services. Goods and services can be used for private purposes or for business purposes. The latter means that goods and services are used by an entrepreneur in the course of his business, which is not considered as consumption. A tax on consumption, therefore, is a tax on final consumption by end-users of goods and services.

## The basic tax elements

All taxes require four basic elements: a taxable event, a tax base, a tax rate and a taxable subject. As regards the taxable event, a tax on consumption cannot under all circumstances be levied when goods and services are physically consumed; durable goods or services may be consumed or used over a long period, goods bought for consumptive purposes may be lost before being physically consumed. Whereas excises are levied when excisable product is relieved for consumption and customs duties are due upon the importation of goods, general consumption taxes are levied at the moment of making expenditures for goods and services received for consumptive purposes. For specific consumption taxes, such as excises on mineral oils, alcohol or tobacco, the volume or quantity of the product acquired can easily be chosen as a tax base (and the rate will be an amount of money per unit of product). For a general tax on consumption, however, the appropriate tax base is the consideration paid for the goods and services and the amount of tax is calculated by applying a tax rate as a percentage of the (net) consideration paid by the consumer.

## Basic objective

The basic objective of a general consumption tax is to achieve a recognizable and strictly proportional and identical consumption tax burden on similar goods and services, irrespective of the length of the production and distribution chain (internal neutrality) and, in the case of a cross-border production and distribution chain, irrespective of the origin of the goods and services (external neutrality).

## Single-stage or multi-stage system

Although from a theoretical point of view it would be possible to levy consumption tax on the final consumer, practice requires a taxable person who can be identified and registered, who charges the tax to his customer and who pays the tax collected to the tax authorities. The collection of consumption tax can take place either at the last stage before final consumption or at more stages of the production and distribution process that precede final consumption. The choice between a single-stage or multi-stage consumption tax is based upon the objective of achieving a transparent and neutral tax burden on final consumption.

A single-stage consumption tax levied at the point where the final consumer makes his

expenditure for the consumption of goods and services (e.g. the retailer) meets the above objective. Levying a single-stage consumption tax at an earlier stage of the production and distribution process (e.g. the manufacturer or the wholesaler) causes the consumption tax as a percentage of the (net) final consumption price to depend upon the value added (and the number of stages) between the stage (and country) of taxation and final consumption. This may lead to lack of transparency and neutrality.

A multi-stage consumption tax can be applied in two forms:

- A cumulative consumption tax, where the tax levied in each stage of the production and distribution chain becomes part of the cost price and therefore will be included in the tax base for consumption tax levied in a following stage; the cumulative system lacks transparency and neutrality;

- A non-cumulative consumption tax, where the tax levied in each stage of the production and distribution chain is fully neutralized in the following stage, until tax is levied on (the expenditure for) final consumption.

A multi-stage non-cumulative consumption tax system can be applied in three forms, i.e. the addition method, the subtraction method and the credit-invoice method:

- In the addition method, tax is levied on the value added by the supplier. This requires a definition of 'added value' as the tax base.

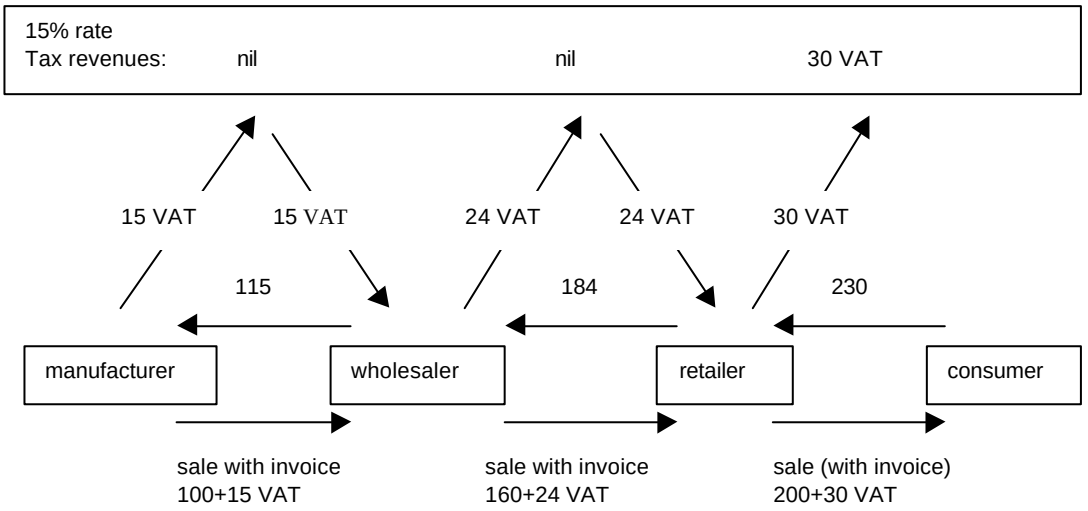
- In the subtraction method, tax is levied on the difference between the proceeds of the entrepreneur (turnover/output, consideration received for supplies of goods and services) and his input (expenditure for goods and services supplied to or received by the entrepreneur).

- In the credit-invoice method, the tax paid is the difference between the tax due on the proceeds of the entrepreneur (turnover/output, consideration received for supplies of goods and services) and the tax paid by the entrepreneur on his input (expenditure for goods and services supplied to or received by the entrepreneur). There should be an immediate deduction or full credit (refund) of input VAT.

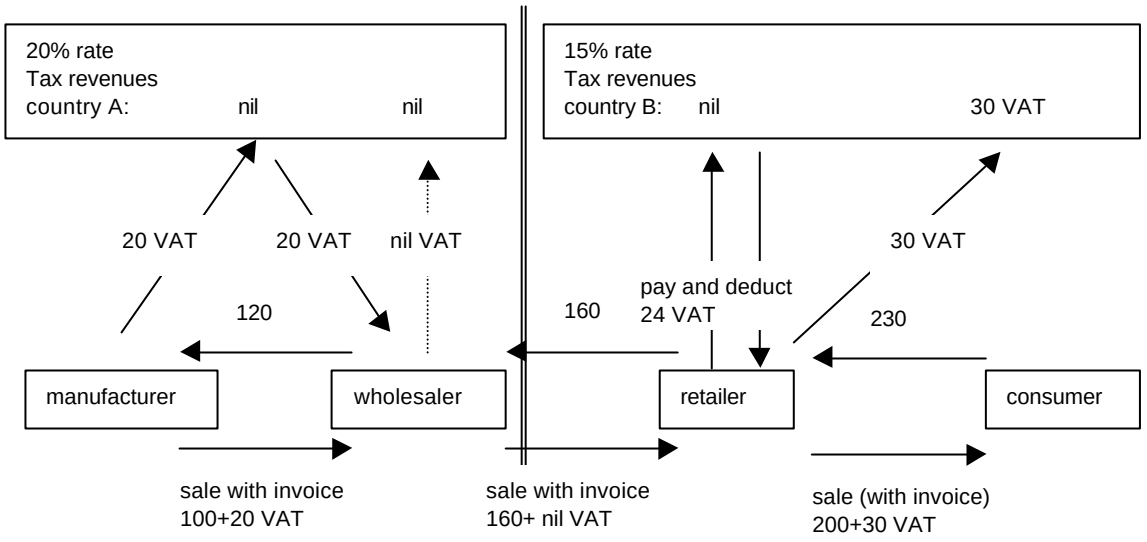
The addition method is the most complex and therefore entails the risk of not meeting the above objectives of a general consumption tax. The credit-invoice method is the most simple and transparent method and is applied in most countries (or regions, like the European Union) that have a VAT system.

The following schemes show the credit-invoice system in domestic and cross-border situations:

*Credit-invoice method in the domestic situation:*




*Credit-invoice method in the cross-border situation*



*Exemptions*

National jurisdictions may decide that specific supplies and services should be exempt from general consumption tax (e.g. for social or health care reasons)[7]. In the credit-invoice VAT method, this leads to non-deductibility of input VAT in relation to expenditures for goods and services used for exempt activities. An exemption in the last stage (sale or service to the final consumer) leads to a final consumption price which includes the input VAT in that last stage. However, VAT exempt supplies and services to entrepreneurs in the production and distribution chain, who perform VAT liable transactions, lead to a hidden and cumulative tax (i.e. the input VAT in the consideration for exempt supplies and services) in the final consumption price.

*The standard*

A standard VAT should adhere to the following criteria:

1. VAT should only burden the final consumption of goods and services.

2. The burden of VAT should be a fixed proportion of the (net) price of goods and services paid by the final consumer, irrespective of the length of the production and distribution chain (internal neutrality).

3. VAT should be levied on goods and services in all stages of the production and distribution chain and the provision of services. VAT-liable persons should be able to recover the full input tax with respect to expenditure used for VAT-liable activities by crediting against VAT due or, in case of a net credit, by a refund of the net credit input VAT. Refund of a net credit amount of VAT should take place at the same time the VAT due for the same tax period would be payable.

4. Exemptions should be limited in scope, in order to avoid distortion of competition with essentially similar goods and services (substitutes) that are taxable and to avoid cumulating taxes if exempt goods or services are supplied to taxable persons.

5. The consumption price of the goods or services should contain no other general consumption tax other than the VAT levied by country of consumption, according to the rate applied in that country for the good or service concerned (external neutrality).

6. Both the tax base (goods and services) and the place of taxation need to be defined consistently at the international level, in order to avoid international double taxation or non-taxation.

7. Administrative requirements for VAT should be simple and should not present a disproportional administrative burden on taxable persons.

[7] Please note the difference between an exemption with the right to deduct or reclaim input tax (equal to the application of a zero rate, as applied to exported goods) and the 'real' exemption, as described above.

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