



# The Application of Consumption Taxes to the International Trade in Services and Intangibles

## Progress Report and Draft Principles

## PRINCIPLES FOR SERVICES AND INTANGIBLES

### Background

1. The rapid growth in international trade has coincided with the global spread of value added taxes with some 140 countries now using such taxes. This growth in international trade has been fuelled by a number of factors, including deregulation, privatisation, technology and globalisation.
2. The revenue from such consumption taxes has increased significantly as a proportion of total government revenues in many OECD countries and beyond in recent years due to a reorientation of tax systems towards taxation of consumption and away from taxation of labour and investment.
3. *Goods* still remain the major item of international trade for OECD countries but in 2002 *services* accounted for 21.9% of total exports of goods and services and 20.5% of total imports of goods and services (respectively 77% and 74% of world export/import of services).
4. The recent analysis by the Committee of Fiscal Affairs (CFA) (CTPA/CFA(2004)34) of the current international consumption tax environment with respect to trade in services and intangibles has shown several symptoms representing obstacles such as double and non-taxation.
5. The significance of the symptoms has, according to the study, been difficult to measure in precise terms, but an analysis of documentation from a variety of sources (including business) has demonstrated a trend and pattern implying that the symptoms are sufficiently significant to require remedies. The CFA report concludes that there seems to be “*a lack of international consistency and coherence*” in the application of this tax to services and intangibles.
6. Therefore, the absence of internationally agreed approaches in the area of services and intangibles which, in the past, may be traced back to a lack of need, awareness or consensus, is now leading to significant difficulties for both business and governments.

### The problems, causes and remedies

7. The CFA’s 2004 report summarised the consumption tax problems for services and intangibles thus:

Double or Inappropriate Taxation	Unintentional Non-Taxation
Lack of supply chain efficiency	Inability to enter markets
Distortion of competition	High compliance costs
Non-compliance	Uncertainty

8. The causes of and the remedies to the problems are largely believed to be:

<b>MAIN CAUSE</b>	<b>RECOMMENDED REMEDY</b>
<b>Lack of internationally agreed principle as to place of taxation in respect of international services and intangibles</b>	<b>Internationally agreed principle as to place of taxation to be approved by the CFA</b>
<b>LEADS TO FOLLOWING SUB-CAUSES</b>	<b>RECOMMENDED REMEDY</b>
<b>Different principles as to approach to place of taxation (origin v. destination)</b>	<b>Internationally agreed principle as to place of taxation to be approved by the CFA</b>
Different approaches and interpretation surrounding key proxies and concepts for determining place of taxation (establishment, use & enjoyment, performance)	Guidance to be approved by the CFA
Different approaches to the interaction of place of supply and time of supply	Guidance to be approved by the CFA
Different approaches to bundled (mixed) supplies	Guidance to be approved by the CFA
No order in interpreting key proxies	Guidance to be approved by the CFA
Other uncertainties	Guidance to be approved by the CFA
<b>CAUSES THAT MAY REQUIRE REMEDY BEYOND CFA APPROVED PRINCIPLE AND GUIDANCE</b>	<b>REMEDY</b>
Lack of general double tax relief in terms of refund or exemption	Remedy possibly to be considered at a later stage
Lack of dispute resolution mechanism	Remedy possibly to be considered at a later stage

### **The task of the Informal Working Group as set out by the CFA and WP9**

9. The task given to Working Party 9 by the CFA is the development of agreed principles and guidance. Those principles and the guidance provide a basis for developing greater awareness of policy issues, and encouraging member countries to remove the identified consumption tax obstacles to international trade in services and intangibles.

10. The first task is to work towards a set of framework principles built on the Ottawa Taxation Framework Conditions as mentioned in the first two elements of the above box (with Secretariat emphasis added). In terms of timing WP9 was asked to draft principles for submission to the CFA for approval at its January 2005 meeting with a view to sending the draft principles to business for consultation.

11. That task was in paragraph 63 of the report, set out as follows:

“... ”

- A progress report together with a draft of high level framework principles for the international taxation of services and intangibles to be considered by the CFA in January 2005 prior to release for public comment.”

12. In paragraph 46 of that report the CFA set out what it believed those principles should deal with:

“46. The Committee believes that these principles need to deal with place of taxation<sup>1</sup> as well as a range of other issues such as establishment, performance and use & enjoyment. Further clarification through guidance on the interpretation of other key concepts or notions leading to different approach should also be sought.”

13. An Informal Working Group<sup>2</sup> established by WP9 was given the task of drafting the principles with a view to WP9 and subsequently the CFA agreeing on submitting those draft principles to business and others, including non-member economies, for input.

### **The progress of the IWG**

14. The IWG has approached its task through a number of conference calls and written correspondence. Further, a joint reply from the Business and Industry Advisory Committee to the OECD (BIAC) and the International Chamber of Commerce (ICC) to the CFA’s 2004 report has been received.

15. The following are extracts from the joint BIAC/ICC statement:

“The international business community supports the approach chosen by the OECD in the Report, i.e. to first identify the problems, then to develop in a first step a set of broadly accepted framework principles, and in a next step to make sure that those principles will be applied in OECD and non-OECD countries. This second part of the project will also cover the problems of dispute resolution and the question in which form compliance with the framework principles shall be ensured (e.g. by a kind of a model tax convention).”

“We also share the opinion that the problems are less acute for cross-border exchanges of goods, since the principle of taxation in the country of destination is generally accepted and tracking the place of supply is easier because goods are tangible. Business and governments are, however, also in this field confronted with conflicting requirements and with problems of double or non-taxation, especially if re-exported or if the physical transactions, and e.g., the billing are not following the same path.”

“BIAC and ICC have come to the conclusion that the OECD is pointing to the core problems encountered in the field of trade in cross-border services and intangibles and the analysis of the problems in the OECD Report, is in general, correct.”

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<sup>1</sup> Secretariat emphasis added.

<sup>2</sup> The IWG is comprised of Australia, Canada, the European Commission, Germany, Italy, Japan, New Zealand, Norway, Spain, and the United Kingdom.

“The international business community agrees in principle with the findings in the table in paragraph 52 (Causes and Remedies) and the proposed steps mentioned in paragraph 63 and is looking forward to a close cooperation with OECD on this important subject.”

“We share the concerns that development of principles and guidance will not be sufficient to solve the problems in practice but that further steps would be necessary. Such a step could be monitoring. The OECD would identify existing problems in certain countries and propose remedies. A more effective form would be a dispute resolution mechanism, but we think that some form of binding commitment is necessary to implement such a mechanism in practice (e.g. bi- or multilateral convention). The most effective way to solve cross-border mismatches in VAT/GST would be an agreement on the application of consumption taxes, either as part of the existing MTC or as a separate bilateral or multilateral agreement. A general application of the destination principle with as few exceptions as possible, together with a general application of reverse charge for B2B transactions, could minimize the need of cross-border registration and refund claims and therefore disburden companies and authorities alike.”

“We strongly plead for the creation of clear rules, being aware that even under clear rules identifying where services should be taxed can be complex particularly where multinational contracts are involved.”

16. There has been discussion in the IWG on a wide range of issues. The discussion has covered:

- what type and level of principles are needed;
- the link to the previous Ottawa work and the broad taxation framework principles that were developed during that process;
- whether general principles underpinning value added taxes should be written down (and, possibly, how they may be applied);
- whether suggested principles will reduce the reported problems;
- whether principles specific for services and intangibles should be developed or if they should have more general application (i.e. also covering goods);
- whether the problems are believed to be caused by administrative as opposed to policy differences;
- whether the reported problems can be solved within the framework of existing rules;
- whether refund/registration mechanisms should be in place to achieve external neutrality and whether this is an issue to address at principle level or at guidance level; and
- what type of consumption taxes should be covered by the principles.

## PRINCIPLES AND APPLICATION<sup>3</sup>

### Place of Taxation

17. Consumption taxes, by and large, set out to tax consumption of goods and services within the jurisdiction where the consumption takes place. However, determining this place of consumption is not a literal exercise and most value added taxes adopt proxies for determining a geographical definition of “consumption”. Almost without exception, jurisdictions impose tax on goods at the place at which delivery takes place. Under this approach imports are taxed and exports are relieved from tax. Thus, a customer, resident in Jurisdiction A might buy a portable computer in that jurisdiction, incurring VAT at the rate applicable there, but use it temporarily in Jurisdiction B. In these circumstances it might be said that some consumption takes place in both jurisdictions, and that Jurisdiction B would have entitlement to some tax on the consumption that takes place there. However, such an approach would be virtually impossible to administer and so jurisdictions generally rely on proxies to determine the place of consumption of goods.

18. For services the situation is often less clear. In general, OECD countries have set out to tax services where they are consumed. As with goods, proxies have been used to determine the place of consumption. For tangible services this may be easier, especially where the supplier and customer need to be in physical proximity in order for the service to be supplied. A hairdresser’s customer probably needs to be reasonably close (at least in terms of jurisdictional proximity) to the hairdresser in order for the service to be successfully completed. But even here “performance” is still only a proxy. Consider the case of a Canadian film star who has her (or his) hair styled in Toronto in the morning prior to attending an awards ceremony in the United States later that evening. “Consumption” might be seen as taking place in the US, but for ease of application it clearly makes sense to adopt the proxy of “performance” in Canada.

19. Acknowledging that the use of proxies for determining consumption exists for both goods and services, the Working Party sees no reason why the taxation of internationally traded services and intangibles should not also be in accordance with the rules of the jurisdiction of consumption. This would be in line with the overall approach of value added taxes and is therefore recommended as a basis for moving forward. The Working Party acknowledges that much more work will be required in order to find appropriate proxies to determine appropriate definitions of consumption. However, taxation in the jurisdiction of consumption is regarded as a basic principle laying the groundwork for the consultation process with business and with non-OECD economies.

### Impact on Business

20. Value added taxes are designed to tax final consumption and as such it is only consumers who should bear the economic costs. There are examples where governments deliberately design these taxes such that there is an economic impact on business (for example, the application of exemption to some sectors, which leads to irrecoverable input tax). However, the general principle underlying value added taxes is that taxable businesses should not incur the tax as an economic cost on goods and services used in making taxable supplies. The Working Party notes that one of the causes of double taxation is the imposition of tax in such a way that services and intangibles are being taxed more than once, with little or no opportunity for deduction or refund. Therefore, it is important to state that in terms of the application of VAT to internationally traded services and intangibles *the Working Party is of the view that, as an underlying principle, VAT should not impose an economic impact on taxable businesses.*

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<sup>3</sup> The governments of Germany and Luxembourg have expressed reservations on this section

## **Significant issues arising from the application of these principles**

21. The Working Party recognises a significant number of difficulties in the application of these principles to the trade in services. These problems are likely to be administrative, interpretative and legislative in nature and highlight the need for the development of more detailed guidance on how to apply the principles.

22. Some of the key issues that will need to be dealt with as a matter of priority include:

- Different approaches to defining place of consumption:
  - origin & destination
  - establishment
  - use & enjoyment
  - performance
- Different approaches to the interaction of place of supply and time of supply
- Different approaches to bundled (mixed) supplies

Issues that may require remedy beyond CFA-approved principles and guidance

- Lack of general double tax relief in terms of refund or exemption
- Lack of dispute resolution mechanism

23. As noted in paragraph 16 above, the Working Party considers that the approaches taken here are in line with those taken for electronic commerce at Ottawa. It further notes that broad taxation principles, such as neutrality, certainty and simplicity, and effectiveness and fairness, should be incorporated into the application of these approaches.

## **NEXT STEPS**

24. The Working Party proposes to hold a consultation meeting with business and with a number of significant non-OECD economies on 17 March, 2005 in Rome alongside, but not part of, the ITD's Global VAT Conference. At that meeting, the principles and approaches as set out above will be discussed, and views will be invited on how the proxies for defining consumption might be developed.

25. The Working Party will also undertake a first draft of Guidance for the application of proxies for defining consumption with a view to presentation to the CFA meeting in the summer of 2005. To the extent that these proxies may require the defining of "establishment" as a proxy for consumption, an initial draft will also be produced.

26. Given that differing approaches by countries to defining time of supply is currently causing significant tax arbitrage opportunities, the Working Party will also approach member countries with a view to establishing current practices, particularly for application of time of supply for advance payments through, for example, pre-paid vouchers. A report on this would then be presented to Working Party 9's June 2005 meeting.