

Report

THE APPLICATION OF CONSUMPTION TAXES TO THE TRADE IN INTERNATIONAL SERVICES AND INTANGIBLES

PREFACE

Governments need to provide a consumption tax environment that facilitates a well functioning services economy and would, at the same time, protect the tax base. The current international consumption tax environment runs an increasing risk of failing to meet both these criteria. The Committee on Fiscal Affairs (CFA) has decided to launch, in co-operation with business and non-OECD countries, a work programme that seeks to address these obstacles to a well functioning services economy and to explore realistic remedies that could be implemented in the short to medium term.

The CFA decided that the first step should be the creation of a set of framework principles for the application of consumption tax to internationally traded services and intangibles. Such framework principles will need to be supplemented by detailed guidance on their application. This guidance will form the second part of this project.

This report, which was approved and derestricted by the CFA on 30 June 2004, identifies potential tax obstacles and provides a first analysis of the issues. It is being issued to encourage a broader debate of the issues. Comments on the analysis can be sent to Jeffrey Owens (jeffrey.owens@oecd.org) by 1 October 2004.

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Introduction

1. Globalisation, deregulation, and technology change have all combined to create enormous changes in the volume and pattern of trade in services and intangibles. Technology and other transformational developments in business supply chains have combined to increase the cross-border supplies of services and intangibles. Businesses with multi-national presence will often seek to specialise or group certain functions in one particular jurisdiction in order to benefit from economies of scale, supply chain efficiencies or other efficiencies such as shared service centres, centralised sales and procurement functions, call centres, data processing and information technology support. As a result the international trade in services and intangibles is growing rapidly and forms a significant and increasing part of international trade¹.

2. Prior to these accelerated developments applying Value Added Tax (VAT)/Goods and Services Tax (GST) to international services and intangibles transactions was less problematic as the supplier and recipient were normally established in the same country and, by and large, consumption took place in the same country. The rapid growth in the trade in international services and intangibles has also coincided with the global spread of consumption taxes like VAT and GST. In the wake of these developments it is becoming clearer that there are difficulties in applying these taxes and reports of obstacles to business activity and economic growth, including significant double taxation and unintentional non-taxation of services and intangibles, continue to grow.

3. A report from the Consumption Tax Technical Advisory Group² in the summer of 2003 (available at <http://www.oecd.org/dataoecd/38/42/5594899.pdf>) raised a number of issues concerning difficulties experienced in the application of consumption taxes to internationally traded services and intangibles. A key issue identified, but not necessarily the only one, was that of double taxation or unintentional non-taxation.

4. In response to this the Committee on Fiscal Affairs (CFA) recommended at its July 2003 meeting that further work on identifying the issues, their causes and their significance should be undertaken before launching any programme of work to deal with the issues. Through the autumn of 2003 a scoping survey was carried out with member governments and a questionnaire for business and others was issued and placed on the OECD website.

5. The results of these surveys demonstrated that there are a range of problems including double taxation but that the issues are varied and complex. As a result the Committee considered that before it could develop a detailed work programme addressing these issues, further work was required in order to develop a better understanding of the consequences, causes and the significance of the problems identified. This further analysis was carried out with continued input from business, academics and selected non-OECD economies and reviewed by the Committee in January 2004. The Committee also noted the wider OECD work, begun in 2003, on enhancing the performance of the service economy and will contribute to this through the consumption tax work on international services and intangibles.

6. In summary, the Committee carried out its work during spring 2004 in the following way:

- Analysis of the issues raised by government and business;

¹ See for instance, OECD and Eurostat (2003), *OECD Statistics on International Trade in Services 1992-2001*, OECD, Paris.

² The Technical Advisory Group consisted of representatives from OECD governments, non-OECD governments and business

- Early involvement from business and others in drawing up a specific work programme;
- Exploration of whether or not an industry-specific approach recognising the interests of both tax administrations and business might be desirable; and
- Further consultation with non-OECD countries.

7. The Committee requested a further analysis of the issues from its Working Party No 9 on Consumption Taxes, together with a structured work programme. This analysis formed the basis of the Committee’s discussion at its June 2004 meeting.

Summary of proposals for future work

8. The analysis of the issues has been approached through various discussions and background papers. A meeting was held with a wide range of business representatives on 3-4 March 2004 providing further input on the issues. Non-OECD government and business representatives were invited to the meeting, with representatives from the governments of Morocco and South Africa attending. That meeting provided considerable additional information enabling the further development of the analysis and the construction of a detailed programme of work to address the issues. The further analysis is set out in paragraphs 19-52 with a proposed programme of work set out in paragraphs 53-63. It has also been considered whether or not an industry-specific approach should be adopted, as opposed to a generic approach. On balance it is felt that a generic approach would be more appropriate although it is recognised that some issues are so specific to certain sectors that exceptions may need to be made to this basic approach. This is considered in paragraphs 59 and 60.

Application of consumption taxes to the trade in international services and intangibles – summary of how it is now

The broad principle that governs consumption taxes such as VAT and GST is that of the final tax falling on the consumer. Business, although responsible for collection of the tax at each stage in the supply chain, should not incur tax as an overhead, and this is achieved by allowing fully taxable businesses to recover all input tax incurred in the process of operating its business activities. The main exception to this principle occurs for businesses making supplies that are exempt from tax, in which case the supplier may incur irrecoverable input tax. Notwithstanding this exception the core principle of the burden of the tax falling on the final consumer applies equally to trade in goods, services and intangibles and it is important to ensure that this is upheld whether supplies are made domestically or internationally.

9. For international trade there is an internationally accepted principle that goods should be effectively zero-rated at export and taxed in the country of import (the destination principle). This ensures that, at least in principle, the goods are taxed where consumed. However, the principles are less clear cut for many services and intangibles, almost certainly because of their intangible nature. Globally there are a number of different approaches to taxing internationally traded services and intangibles, most of which probably set out with the intention of taxing where consumption takes place, but nevertheless do not always produce the symmetrical balance needed to avoid double or unintentional non-taxation.

10. At a primary level, the taxing rights that each country asserts depend on whether the country uses a system for place of taxation that is *origin*-based, *destination*-based or a mixture of the two.

11. Under an “origin” model services and intangibles are taxed in the country where the supplier is based unless they are specifically defined as being taxed somewhere else. Those countries that use this

model make many exceptions to this basic rule in order to try to achieve taxation in the country of consumption. In many cases these exceptions are so numerous that only a few supplies of services and intangibles actually remain taxed under the origin rule. These exceptions have to be defined in legislation in order to be excluded from the basic rule. The intangible nature of many services is such that defining services is not always an easy task, and it is not unusual for cases to be brought before courts of law in order to determine the place of taxation. Frequently such cases will turn on the precision of the drafting of the legislation.

12. Other countries use a “destination” model under which services and intangibles are taxed where the customer is based. The approach sets out to tax services and intangibles consumed within the jurisdiction and relieve from tax services and intangibles provided by a supplier established within the jurisdiction for consumption outside of the jurisdiction. Although this approach may be seen as more adapted to a globalised world, especially in the light of the Ottawa Taxation Framework Conditions for e-commerce, it is not without its own problems. There are, for example, significant practical issues in collecting tax at the place of consumption, both on supplies to business and consumers. The approach generally relies on proxies to describe services and intangibles that are considered to be supplied for consumption outside of the jurisdiction and therefore relieved from domestic taxation.

13. The global situation is therefore that some countries are taxing on an origin basis (albeit with many exceptions), whilst others tax on a destination basis (also with exceptions). Both approaches, with their exceptions, appear to have the objective of taxing services and intangibles at place of consumption.

14. At the secondary level, both approaches often use proxies to establish the exact place of taxation. Proxies can include the supplier’s or recipient’s residence or permanent/fixed establishment, the physical place of performance, and the place of use & enjoyment. These proxies, when applied by different countries have the potential for conflict, especially given that there are also uncertainties as to their interpretation and application.

15. In addition there are a number of other variations to the application of consumption taxes in the context of international services and intangibles such as:

- different interpretations of the same or similar concepts;
- different approaches to time of supply and its interaction with place of supply;
- different definitions of services and intangibles; and
- inconsistent treatment of bundled supplies.

16. Consumption taxes such as VAT and GST are relative newcomers to the world of taxation. Although some 50 years have passed since their inception the real growth has occurred in the last 20 years. When international trade was characterized largely by sale of goods, there was little need for global attention to be paid to services and intangibles, which, as noted above, were primarily traded within domestic markets. That situation has changed dramatically in recent years, and the absence of internationally agreed approaches, which can be traced back to that lack of need is now leading to significant difficulties for both business and governments. There is, for instance, nothing in place to address the consequences of all the different approaches as set out above, such as double and unintentional non-taxation. Nor is there any mechanism available to settle international double consumption tax disputes.

17. What do exist are refund schemes of VAT/GST incurred by foreign business, or registration procedures in certain countries to achieve the same effect, which are intended in part to address some of the consequences of different approaches (double taxation and lack of external neutrality). Such schemes, however, apply in some 30 countries (most but not all OECD countries and a few non-OECD countries). Some, but not all, countries require reciprocity in order to grant a refund, and this reciprocity appears to be addressed through domestic law rather than treaties. Furthermore, a few countries apply unilateral relief in the event a transaction is taxed in another jurisdiction. A few bilateral treaties mention value added taxes in respect of ships or aircraft in international traffic. A number of countries have exchange of information provisions also covering value added taxes, based on Article 26 of the Model Tax Convention on Income and on Capital. Finally, there are examples of treaties with non-discrimination provisions covering value added tax.

18. Overall, therefore, there is a lack of international consistency and coherence in the application of consumption taxes such as VAT/GST to international services and intangibles.

The analysis and recommended approach

19. Analytically the task has been approached in the following manner:

- I. Identification of the issues, through actual examples provided by business and governments, of symptoms representing problems having an impact on business and revenue.
- II. In analysing those problems, establishing the causes of the problems and their significance.
- III. Identifying options to address the problems.
- IV. In recommending a work-programme to tackle the problems, suggesting remedies that would appear as realistic in the short/medium term, also recognising that over time other options might be further explored.

I. Identification and presentation of problems

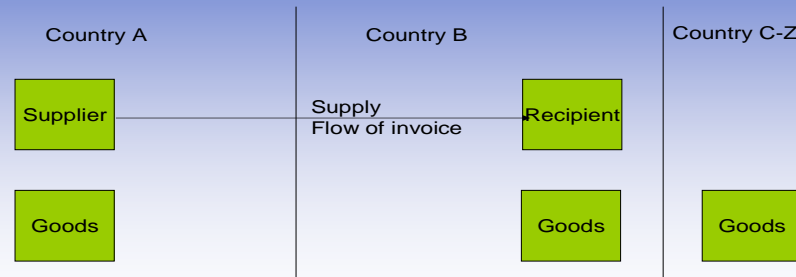
20. As mentioned in paragraphs 3-8, the issues have been identified over a period of time through the previous TAG work on e-commerce, the scoping surveys, various background papers and the recent meeting with business. Further, the OECD from time to time receives informal input from business through conferences, meetings and correspondence. The International Chamber of Commerce (ICC) recently forwarded its 2004 Policy Statement on “Deficiencies in VAT Systems” to the Secretary General of the OECD. In identifying and presenting the problems, the Committee has therefore relied on a variety of sources both directly and more indirectly linked to the process of this work. The following examples are provided to illustrate, highlight and summarise the complexity, the symptoms and the causes of most of the issues identified.

Examples

Example I

Approaches to Place of Taxation Clashing Principles and proxies

Operational or finance lease of goods



1

Depending on the countries involved the following might occur:

1. The lease is taxed in country A because the supplier is established there or alternatively because the goods are located/imported there
2. The lease is taxed in country B because the recipient is established there or alternatively because the goods are located/imported there
3. The lease is taxed in country A because the supplier is established there and in country B because the recipient is established there and in country C-Z because the goods are physically located/imported there.
4. The lease is taxed nowhere because country A view place of taxation as where the recipient belongs or alternatively where the goods are located and country B view place of taxation as where the supplier is established or alternatively where the goods are located. The country where the goods are located view place of taxation as where either the supplier or the recipient is established.

21. This example touches upon the symptoms (non-, double or triple taxation) caused by different approaches to the principle of origin or destination and is further complicated by different approaches to, and no order in, interpreting the underlying proxies of establishment and use & enjoyment. In addition uncertainties appear as the tax consequence would depend on the classification of the lease as one of a supply of goods or services and the type of goods subject to a lease arrangement.

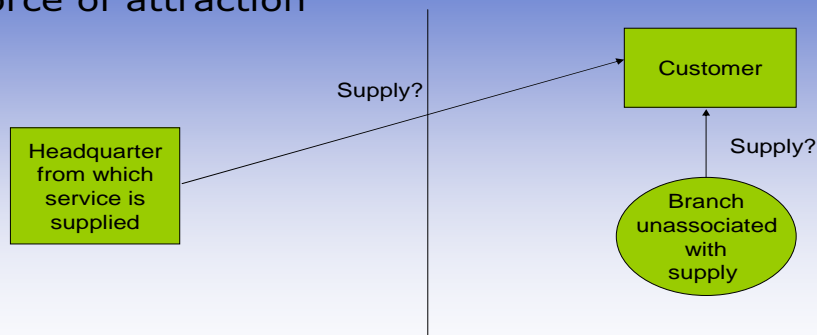
The Committee feels that this example illustrates well the core of the problem:

- (i) a lack of high level agreed framework principles on place of taxation;***
- (ii) conflicting underlying proxies; and***
- (iii) varying interpretations of the same or similar concepts.***

Example II

Establishment Issues

Force of attraction



1

The above is merely one example of uncertainties in respect of establishment issues. The specific example relates to whether *only supplies attributable* to a branch are subject to VAT/GST by the branch or alternatively whether *all supplies* to customers in the country of the branch are subject to VAT in situations where the branch is unassociated with the supply (source/force of attraction). Globally there seem to be a number of uncertainties surrounding the VAT/GST establishment concept. Below are listed a few examples as to current uncertainties and where approaches seem to differ:

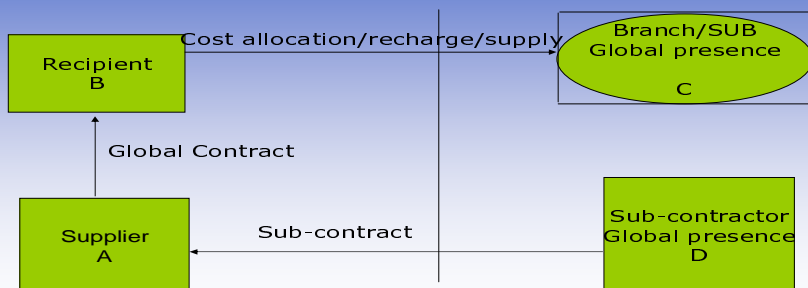
1. Terminology (establishment, permanent establishment, fixed establishment, place of business, fixed place of business etc);
2. Further definition of VAT/GST PE;
3. Whether tax treaty definitions or domestic income tax law are irrelevant/relevant/instructive to interpreting the VAT/GST PE concept;
4. Whether a PE for one tax triggers a PE for another or raises a red flag;
5. Whether a PE as identified under income tax law or treaty definitions must register for VAT/GST purposes;
6. Whether/in what circumstances a VAT/GST PE is a requirement for a foreign resident to register and to be liable to charge VAT and obtain a credit of VAT on costs incurred (nexus);
7. Whether a VAT/GST registration can be obtained in the absence of an income tax PE;
8. Whether a pure VAT/GST registration in some circumstances is deemed to be a VAT PE;
9. In case of multiple establishments (and if a supply should be attributed to the PE) what are the existing rules or guidelines for the attribution. In other words which establishment is making or receiving the supply; and
10. Branch-to-branch/headquarter-to-branch supplies
 - a) whether transactions within one legal entity are/should be taxable (deemed) supplies
 - b) whether contract route or overriding use & enjoyment criteria (should) apply (whether deduction should be allowed in contracting recipient branch when use & enjoyment takes place in branch abroad)
 - c) whether reverse charge is/should be used to tax a (deemed) supply in a branch-to-branch transaction
 - d) valuation (whether income tax transfer pricing valuation applies/should apply or whether actual subjective consideration should be decisive)

22. Reported consequences of the above are uncertainties, double, inappropriate, and non taxation, non-compliance, high compliance costs, restructuring and show-stopper for development of various business models and a restriction on entering markets.

The Committee views the current uncertainties in this area as unsatisfactory and an area where clarification would be desirable. This is expected to be a wide issue as it impacts all type of industries (and may also touch upon the supply of goods).

Example III

Global Contract



A wishes to enter into a contract with B to deliver services to B and its subsidiaries/branches around the world (C). A would buy services from its subsidiaries or third parties (D) to fulfil the contract with B. A wishes to do so to secure a sale to a large customer by offering a single point of reference and a discounted price. B is interested because it will have one point of reference in terms of customer care and price. Close to finalising the deal the VAT/GST impacts are assessed and the consequences are such that they are likely to create obstacles sufficient to outweigh the desired supply chain efficiencies. The uncertainties and or VAT/GST overhead make the contract unattractive for both parties. The reasons for this are:

1. A would charge VAT/GST to B
2. 1 B may reclaim the VAT/GST
- 2.2 B may not reclaim the full VAT because (i) part of the service is used by a branch abroad or (ii) B is a partly exempt business with partial recovery.
3. B would make a recharge to C which, depending on the nature of the service and country involved may or may not be subject to VAT by B. If subject to VAT C may not be able to obtain a refund of the VAT incurred in the country of B.
4. C may or may not account for VAT on the acquisition depending on the nature of service, whether the country in question would apply reverse charge or import VAT on services and, if C is a branch, whether it is required to self account for VAT/GST under deeming rules for branches. Depending on nature of the business C may only partly recover the VAT. Further there may be uncertainties as to the valuation of the recharge.
5. D may or may not charge VAT to A depending on the nature of the service and whether use & enjoyment takes place by C in its country.

As A does not have certainty about the VAT/GST costs of the transaction, A is concerned and wishes to implement the following clause in its contract with B. "All sums due to A under this Contract are exclusive of VAT/GST, and any other applicable taxes, levies or charges which may apply or be introduced in the Countries covered by the Contract, which shall be paid by B."

B is not willing to enter into a contract under which the total price including taxes is not known. The contract is not signed and A and B are unable to utilise an available supply chain efficiency.

23. Business identifies global contracting as an area where significant supply chain efficiencies can be obtained. However, the problems and uncertainties surrounding the application of consumption taxes are such that frequently these contracts cannot be completed, or are completed to a limited extent, thereby reducing the potential efficiency gains. This may well affect a business's competitiveness and is an obstacle to the growth in the international services economy. For those contracts that are completed there may well be high compliance costs that might, in turn, discourage compliance.

The Committee recognises the growing importance of global contracts but is aware that VAT/GST application can be an obstacle to their development. Multinational enterprises seek to transform existing business dealings into new or broader relationships, to grow revenues, and to increase efficiencies and take advantage of synergies within the enterprise. However these advantages would be lost if the initiatives result in additional tax and compliance costs that exceed the additional revenue or cost-saving achieved.

The symptoms impacting on business and revenue

24. The results of the analysis of the identified problems are such that the symptoms representing problems impacting on both business and revenue can be summarised 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

Double or inappropriate taxation

25. Unlike direct taxes there is no common understanding of double taxation for consumption taxes. Double or inappropriate taxation might arise in the following situations:

- different taxpayers (i.e. both the supplier and the recipient) are subject to tax on the consideration from the same transaction;
- the same legal entity is subject to tax twice on the consideration through being deemed to be different taxpayers (both the supplier and the recipient e.g. in a branch-to-branch scenario); and
- a business is input taxed on an acquisition (as it has limited recovery or incurs foreign VAT/GST not refundable) and is output taxed on its supplies.

26. What conceptually is – and is not – double taxation is, in the Committee's view, of secondary importance in this respect. What is of primary importance is that the above symptoms may require remedies irrespective of whether the issues should be labelled as double taxation under traditional definitions. What appears to be double taxation may not necessarily actually lead to double taxation even if both the supplier and the recipient are required to account for tax. For example if a management service

is subject to VAT in both country A where the supplier is established and country B where the customer is established, the customer in country B may obtain a refund in country A and at the same time be able to deduct VAT incurred in country B. VAT will then not be a (VAT) cost for business with a full right to recover VAT and presumably VAT works as it should, albeit in a way that may lead to increased compliance costs.

27. However, refund schemes³ currently apply in no more than about 30 countries around the world and arguably economic double taxation will occur when other countries are involved. Secondly, if the supplier in country A does not charge VAT on the transaction (which may be right or wrong according to domestic law) he might be assessed by the authorities in country A. This VAT, interest and penalty cost may often need to be absorbed by the company in country A. He may pass on the VAT amount itself (without penalty and interest) by the issuing of new invoices to the customer. However, as a remedy to the double tax situation, this approach might be practically impossible many years after the supply. If a (partly) exempt business were introduced into the example above, double taxation and/or cascading effects would occur.

28. The current environment, with a number of different approaches to place of taxation as described in paragraphs 10-15, has the potential to lead to actual double or inappropriate taxation. That this currently takes place is reported by business with respect to a broad range of services including cross-border leasing, global contracts, global roaming, multifunctional prepaid calling cards, bundled services, management services, other intra-company charges, and advertising services.

29. Paragraph 1 of the introduction to the Model Tax Convention states: “[Double taxation’s] harmful effects on the exchange of goods and services and movement of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries.” The Committee sees no reason why this statement, by the Council of the OECD, should not have equal application to consumption taxes.

Unintentional non-taxation

30. Due to the symmetric nature of VAT/GST, theoretically non-taxation should occur as frequently as double taxation. Further, the remedy for double taxation at first sight appears appropriate for non-taxation. In other words if the problem of double taxation is reduced so should the problem of non-taxation. However unintentional non-taxation would be present only if exempt business or consumers pay less tax than the tax calculated as a function of the rate applicable to the consideration. The issues would therefore not necessarily be completely symmetric. For example where tax is not due in a B2B transaction and the parties would have full right to recover input VAT/GST had the transaction been taxed, non-taxation may be fully intentional and appropriate. On balance, however, the Committee believes that a remedy addressing double taxation would, to a large extent address, unintentional non-taxation as well.

Uncertainty – Difficulties in accessing markets - Lack of supply chain efficiency

31. Although these issues were frequently mentioned in the earlier surveys there was insufficient explanation to allow an assessment of their causes and significance. There was a greater explanation by business during the 3-4 March meeting of how the mismatches in the application of VAT/GST are affecting the ability to enter markets. In particular they stressed that, in the absence of a global overarching understanding about the application of these taxes, there were major uncertainties.

³ Refund schemes have often been criticized for being costly to both administrations and claimants.

32. The foregoing examples regarding establishment issues and global contracts illustrate clearly the uncertainties that lead to difficulties in entering markets or in exploiting business opportunities. This uncertainty, coupled with double tax implications, further lead to obstacles to the development of a well-performing international service economy.

33. Frequently companies have little choice but to absorb VAT/GST into their costs thus making the services they supply more expensive and possibly making the supplier less competitive. Whilst this, on its own, might be of limited immediate concern for tax authorities it does impact on supply chain efficiencies. One business representative made the point that computers that, a few years ago, cost \$2500 now may cost less than \$600 and that price cut has come about through better use of supply chain efficiencies. The same is not happening with services where the VAT/GST uncertainties give rise to supply chain inefficiencies (e.g., difficulties in securing global contracts) and thus the fall in prices is much slower. Whilst there may be an element of over-emphasis by business in this respect, it would be a reasonable assumption that the uncertainties inherent in the application of VAT/GST to internationally traded services are having an impact on the development of the service economy.

High compliance costs – Non-compliance

34. Apart from the day-to-day costs of dealing with the uncertainties, many businesses (particularly multinationals) involved in, for example, the supply of installation, repair, maintenance, and training services, and a number of services caught by use & enjoyment override rules, may be required to maintain multiple VAT/GST registrations. Also the use of global service contracts with elements of local delivery of goods will have the same consequence. The effect of this may be high compliance costs or non-compliance.

Distortion of competition

35. The different treatment of national and foreign companies in respect of the deductibility of VAT/GST -- being deductible for nationals and not for foreigners -- arguably leads to a lack of external neutrality and distortion of competition, and may have implications under the WTO's GATS rules.

36. Further, if a foreign supplier escapes VAT/GST whilst a domestic supplier has to charge tax, there is a similar distortion. This remains a problem particularly in a B2C situation but also in a situation where the recipient is not, or only partly, entitled to deduct input VAT/GST (to the extent "import" of services and intangibles are not taxed by a business recipient).

Significance of the symptoms

37. As mentioned above the issues have been identified over a period of time through various inputs. During the meeting with business on 3-4 March, government delegates met with 20 representatives from a cross-section of business and geographic regions. Two non-member countries also attended (South Africa and Morocco). The objective of the meeting was to undertake, and get input to, the further analysis of the issues raised by business and governments in the surveys carried out in the second half of 2003. In particular input on the impact of the problems on market economies as well as impacts on bottom line was sought. Stress was placed on the significance of these impacts.

38. Generally the Committee is satisfied that the explanations provided by business indicate that there are several symptoms that appear on an ongoing and frequent basis. As expected, it has been difficult to measure their significance in terms of tax cost, compliance costs or revenue losses related to the inability to enter markets or achieve business efficiencies. Business input has, however, focused on recurring and frequent actual examples and symptoms rather than one-off or more theoretical examples.

Some comments from business:

“our consumption tax specialists come across double taxation issues on a daily basis”

“we have focused on providing frequent and ongoing actual examples rather than theoretical examples”

“declining of markets and not utilising business efficiencies happens all the time with e.g. global contracts”

“annual consumption tax cost for the European telecommunications industry on one limited issue alone (global roaming) is estimated to be €400 million”

39. The OECD received further feedback at a global indirect tax conference where some 200 consumption tax specialists indicated that the problems are sufficiently significant to require broad geographical remedies and that the OECD is well placed to tackle the issues. Further the International Chamber of Commerce (the world business organisation) has recently written to the Secretary General of the OECD with a policy statement on deficiencies in consumption tax systems including several recommendations for remedies. Several of these “deficiencies” are identical, or closely related, to the issues raised in this report.

40. The Committee notes the difficulties in precisely quantifying the impact of these issues. These difficulties are the result of a number of factors, including access to reliable data, taxpayer confidentiality and a lack of information, particularly amongst tax administrations, in respect of non-taxation. However, given the persistent threads that run through the issues raised in paragraph 20 (including the report from the TAG in 2003, the surveys conducted later in 2003 and the subsequent input received from business) and the complexity and range of issues highlighted in the examples, the Committee believes that the problems are not merely theoretical. On balance, the Committee believes that the current international consumption tax environment leads to obstacles to international trade to the extent that the impact on both business and revenue calls for remedies.

II. The causes

41. The relevant question to ask in addressing the symptoms would appear to be: “Why are there instances of double taxation, inappropriate taxation, unintentional non-taxation, lack of supply chain efficiency, businesses declining entry into markets, high compliance costs and non-compliance and distortion of competition?”

42. The Committee feels that a fundamental shortcoming in the application of VAT/GST to services and intangibles is the absence of internationally agreed principles to determine where taxation should take place. As noted in paragraph 9 the situation for goods is much clearer and the Committee notes that for electronic commerce it was possible to achieve broad agreement on taxation at the place of consumption through the Ottawa Taxation Framework Conditions. However, developing principles for a much broader range of services and intangibles is likely to be more complex.

43. Further, conflicting proxies for place of taxation such as establishment, use & enjoyment and performance, and the order and uncertainties as to their interpretation, appear to be a serious concern to, and cause of, the symptoms identified. Uncertainties and different interpretation of the same or similar concepts beyond the proxies mentioned above also cause problems.

III. The remedies

44. A number of options have been suggested to address the current situation. In an OECD context the following would seem most relevant:

- (i) encouraging countries to reduce the current obstacles to international trade through an agreed framework of principles;
- (ii) the development, with appropriate business input, of a Guidance Series that translates the framework principles into a set of workable “rules”. In so doing it would be essential to bring non-OECD economies into the debate as the problems identified are not limited to OECD countries; and
- (iii) because it is unlikely that the development of principles and guidance will, on their own, be sufficient to eliminate all of the problems, and inevitably countries will interpret concepts or activities in different ways, some form of dispute resolution mechanism might be needed. Alternatively, where countries think that a bilateral agreement on the application of consumption taxes to services and intangibles traded between their countries might be of use then a Model Tax Convention (MTC) on VAT/GST (or inclusion of VAT/GST articles in the existing MTC on Income and On Capital) might be appropriate;
- (iv) there will also need to be ongoing monitoring of the situation, especially as new business models emerge, and further, deeper analysis of the obstacles identified.

45. In terms of process and formal output, the first step would be the development and approval of the framework principles by the Committee. These principles could then, if thought desirable, be sent to the Council of the OECD for approval and recommendation to member countries. Following agreement on the principles, guidance would be developed within the Consumption Tax Guidance Series for approval and, if thought desirable, for approval and recommendation to member countries by the Council. At this stage it is too early to set down an exact process beyond approval by the Committee, and options for further approval can be explored later if felt desirable.

46. The Committee believes that these principles need to deal with place of taxation 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.

47. In the short to medium term, and bearing in mind what may be realistic, the Committee recommends an approach involving the first step as set out in paragraph 45 above. The principles and the guidance would be a means of developing greater awareness of the policy issues in such a way that member countries would be encouraged (as opposed to being bound) to apply them. This should, over time, lead to a reduction of the conflicts and obstacles to international trade. Such an approach would also imply that where there is clear consensus amongst the member countries, administrations should consider the principles and guidance in light of their existing consumption tax systems and their legislative approaches.

48. The next question is inevitably whether more binding types of mechanisms might be considered again bearing in mind what would be expected to be realistic in the short to medium term. The current environment for income taxes might illustrate this by the existence of a broad network of binding bilateral treaties based on a common model recommended by the Council and freely entered into by the treaty partners. But even with such instruments there may still be a need, as with direct taxes, to further develop effective dispute resolution mechanisms.

49. In the context of consumption taxes, it may, for example, be questioned whether certain OECD and a substantial number of non-OECD countries might introduce refund of VAT/GST schemes or similar arrangements to foreign business because of CFA “agreed” principles and guidance that would potentially be approved and recommended by the Council. Further, when a conflict occurs and a business is subject to double taxation, such principles and guidance may not always provide an environment in which a dispute can be resolved with binding effect.

50. The Committee is therefore very well aware of the fact that over time remedies beyond framework principles and guidance might be required. For example treaties based on a common model have been suggested by some representatives of both governments and business as a possible remedy to the problems at hand. An example of the latter is the International Chamber of Commerce’s recent policy statement on “VAT Deficiencies”. That contained a number of recommendations in order to avoid deficiencies in consumption tax systems, the first of which is:

“The problem of international mismatches...and conflicting rules for the place of taxation should be solved by applying ...identical rules 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.”

51. On balance and bearing in mind what would seem realistic in the short to medium term, the Committee recommends that the programme now should focus on addressing the lack of framework principles of taxation for international services and intangibles, and it believes that this and the guidance to be approved by the Committee (and potentially Council) would provide a policy tool which over time may sufficiently reduce the current obstacles to international trade. In terms of further remedies, options on the further outcomes from this process can be considered at a later date. This may include looking at the role played by existing international tax arrangements in order to further reduce any potential for instances of double taxation and other symptoms.

52. The following table illustrates the causes and the remedies in terms of OECD output⁴:

MAIN CAUSE	RECOMMENDED REMEDY
Lack of internationally agreed principle as to place of taxation in respect of international services and intangibles	Internationally agreed principle as to place of taxation to be approved by the CFA
LEADS TO FOLLOWING SUB-CAUSES	RECOMMENDED REMEDY
Different principles as to approach to place of taxation (origin v. destination)	Internationally agreed principle as to place of taxation to be approved by the CFA
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
CAUSES THAT MAY REQUIRE REMEDY BEYOND CFA APPROVED PRINCIPLE AND GUIDANCE	REMEDY
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

IV. The proposed work programme in terms of why, what, how and when

Why something should be done

53. The Committee believes that, considering discussions in other subsidiary bodies of the Committee on issues arising under income and capital taxes, governments need to provide an environment with fiscal rules for consumption taxes that facilitate a well functioning services economy and that, at the same time, protect the tax base. The Committee also believes that the current international consumption tax environment leads to symptoms representing obstacles to international trade and impacting both business and revenue to an extent that it calls for remedies. The Committee is therefore launching a work

⁴ Grey field implies: “possibly to be considered at a later stage.”

programme that seeks to address the causes of the obstacles to a well functioning services economy and to consider where and how these might be remedied.

What needs to be done

54. In addition to ongoing monitoring and continuing analysis of the issues, the Committee will work towards an agreed set of framework principles for the application of consumption tax to internationally traded services and intangibles. This would build on the Ottawa Framework Principles and allow for a more comprehensive international understanding of the application of consumption taxes.

55. Such framework principles would be of limited use on their own and both the principles, the underlying proxies such as establishment, use & enjoyment and performance and other causes of the current problems, would need significant explanation, guidance or commentary if they are to be of practical value to and implemented by users. This guidance would be required in order that the Principles are applied in a consistent manner.

56. In terms of outcomes the existing “Consumption Tax Guidance” series will be developed into the leading guidance for governments (both OECD and non-OECD) on applying VAT/GST to international trade. The framework principles and the guidance could over time develop into “A model framework for applying consumption taxes to international services and intangibles”.

How it will be done

57. The Committee’s Working Party 9 on Consumption Taxes will take this work forward and, with input from business, develop a draft set of framework principles. Involvement of non-OECD economies will be a high priority in this task and they will be consulted on how they would like to contribute.

58. In order to involve business in drafting the guidance it will be essential to ensure input from the business community to leverage on their experience. Business has both the knowledge of the industry and is more acutely aware of the change in environment.

59. The Committee makes the following preliminary observations as to whether or not an industry-specific approach might be a desirable way forward noting that it may be premature to provide a recommendation at this point. It has been difficult to ascertain whether some symptoms and causes are more significant than others and whether the launching of an industry-specific or issue-specific programme should be recommended. For example certain issues such as branch-to-branch (and Head Office-to-branch) issues are likely to be more significant in the financial services sector because of non-tax regulatory requirements that govern the sector. On the other hand a branch structure is not limited to this industry and that potentially all multinationals have branch issues in several jurisdictions. Certain telecommunications issues may be industry-specific (e.g., global roaming and the application of the Melbourne Agreement). However, the cause of this is broader, such as the limited application of refund of foreign VAT/GST.

60. Although the work may at first sight appear to be easier to manage if a more limited industry- or issue-specific approach is recommended, this approach is not without disadvantages. On balance the Committee believes that most of the issues are linked and have consequences beyond a specific industry. By going back to the previous e-commerce work, several issues were recommended to be considered in a broader perspective and clear guidance was not given because of a wider application. Secondly, industry fire-fighting would easily become outdated and potentially involve distortion of competition to industries involved in similar services. The Committee therefore believes that a general approach rather than an industry-specific approach seems to be the best way forward. Having said that, as issues evolve and the level of detailed output required becomes more apparent, it may be that certain issues might require a

separate strand of work. In general it is anticipated that issues with a broader implication than just services and intangibles, such as establishment issues, may require an issue-specific approach.

61. Details on how business input will be structured will be considered by the CFA at its January 2005 meeting. Meanwhile the Committee suggests as a starting point that ad hoc discussions be held with business representatives, taking into account appropriate geographical and industry spread, in the development of the framework principles.

62. Given that many of the problems identified are global it will be of paramount importance to involve non-OECD economies in the process. Consideration will be given to creating a separate forum of non-OECD governments, possibly using the OECD's links with the Committee of International Organisations of Tax Administrations (CIOTA) and, through the International Tax Dialogue (ITD), with the IMF and the World Bank.

When it will be done

63. Bearing in mind that guidance in respect to e-commerce took several years to develop, it should be clear that the development of both the framework principles and the guidance to services and intangibles in general is a much broader work and will require the appropriate time in order to produce a quality product. The following indicative timeline is suggested:

- 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.
- Consideration and approval of a final draft by Working Party 9 at its summer meeting in 2005 for submission to the summer 2005 meeting of the CFA.
- Developing guidance on implementing the principles and main proxies (such as establishment, performance and use & enjoyment) and their interaction starting as soon as the principles are approved by the Committee.
- Progress reports should be submitted to the January 2006 and 2007 CFA meetings.
- A more detailed work plan about any further guidance would be considered during 2005.