OECD INTERNATIONAL VAT/GST GUIDELINES

DRAFT CONSOLIDATED VERSION

INVITATION FOR COMMENTS

FEBRUARY 2013

Committee on Fiscal Affairs
Working Party N°9 on Consumption Taxes

IMPORTANT NOTICE

The OECD's Committee on Fiscal Affairs invites public comments on four new draft elements of the OECD International VAT/GST Guidelines (the Guidelines). These four interim drafts relate to (i) a preface to the Guidelines; (ii) the core features of VAT-systems to which the Guidelines are intended to apply, (iii) place of taxation for cross-border supplies of services and intangibles to businesses that have establishments in more than one jurisdiction, (iv) implementation of specific rules for determining the place of taxation for cross border business-to business supplies of services and intangibles.

The OECD is developing the Guidelines to address uncertainty and risks of double taxation and unintended non-taxation that result from inconsistencies in the application of VAT to international trade, with a specific focus on trade in services and intangibles. For ease of reference, the Committee on Fiscal Affairs considered it useful to present the interim drafts that are now released for public consultation, in one consolidated document together with the elements that were published before. It should be noted that this work builds on the assumption that parties involved act in good faith and that all supplies are legitimate and with economic substance. Issues connected with tax evasion and avoidance will be addressed as part of future work. Detailed reference to the draft elements on which comments are now invited has been added at the beginning of each of the chapters of the consolidated document.

Please bear in mind that these draft consolidated Guidelines are work in progress and that this is not necessarily a consensus document. One or another country may not be in full agreement with one or more of its provisions and this work should therefore not be considered, at this stage, as final or binding. Nevertheless, the Committee on Fiscal Affairs believes that it will be extremely helpful to its ongoing work on the development of the Guidelines to receive input from all interested stakeholders.

Written comments can be provided by individuals or on a more collective basis by industry bodies or by professional advisory firms. Authors of comments and specific contributions are kindly requested to identify themselves, as we may need to follow-up with them on their responses. Unless otherwise requested at the time of submission, comments received will be posted on the OECD website.

Please send your written comments **by Friday 3 May 2013** in Word format by e-mail to Piet Battiau, Head of Consumption Taxes Unit, Centre for Tax Policy and Administration at piet.battiau@oecd.org.

INTERNATIONAL VAT/GST GUIDELINES

DRAFT FOR PUBLIC CONSULTATION

1. Background

The OECD is developing *International VAT/GST Guidelines* (the Guidelines) to address uncertainty and risks of double taxation and unintended non-taxation that result from inconsistencies in the application of VAT to international trade, with a specific focus on trade in services and intangibles. These Guidelines build on two core principles that were adopted by the OECD's Committee on Fiscal Affairs in 2006:

- The *'neutrality' principle* whereby VAT is a tax on final consumption that should be neutral for business.
- The *'destination' principle* whereby internationally traded services and intangibles should be subject to VAT in their jurisdiction of consumption.

The Guidelines do not impose legally binding VAT rules on countries or prescribe legislative approaches. Their design and consistent implementation is intended to serve as a basis for countries to frame their own laws and administrative practice, reduce impediments to international trade and improve the neutrality of VAT regimes worldwide while reducing opportunities for tax avoidance and creating more certainty for business and tax authorities.

The Guidelines are being developed by the OECD Committee on Fiscal Affairs through its Working Party No 9 on Consumption Taxes. The business community is actively involved in the development process. For this, a Technical Advisory Group was created with government and business representatives and academic experts.

The Guidelines are being developed in stages. The output from each stage is a building block contributing to the complete Guidelines. Since the start of this project, public consultations have been held on (i) draft Guidelines on neutrality of VAT in the context of cross-border trade, (ii) a draft Commentary for the application of the Guidelines on neutrality in practice and (iii) draft Guidelines on place of taxation for cross-border supplies of services and intangibles to businesses that are established in one jurisdiction only.

The Committee on Fiscal Affairs now presents the following drafts for public comment:

- A draft Preface of the Guidelines;
- A draft Chapter 1 of the Guidelines, on the core features of VAT-systems to which the Guidelines are intended to apply;
- Draft Guidelines on place of taxation for cross-border supplies of services and intangibles to businesses that have establishments in more than one jurisdiction;
- Draft Guidelines on the implementation of specific rules for determining the place of taxation for cross border business-to business supplies of services and intangibles.

For ease of reference, the Committee on Fiscal Affairs considered it useful to present these new interim drafts in one consolidated document together with the elements that were published before. This may make it easier to read cross-references to earlier work and to understand the scope and the overall structure of the

Guidelines. Detailed reference to the latest drafts on which comments are now invited has been added at the beginning of each of the chapters of the consolidated document.

It should be noted that these draft consolidated Guidelines do not present the full set of Guidelines that are expected to form the final output of this project. In particular, the Committee on Fiscal Affairs still intends to develop Guidelines on place of taxation for cross-border supplies of services and intangibles to final consumers ("B2C") as well as anti-abuse provisions and provisions on mutual cooperation and dispute resolution. The objective is to arrive at a complete set of Guidelines applying to cross-border trade in services and intangibles by the end of 2014.

2. Further information on the drafts that are now released for public consultation

The drafts on which public comments are now invited are the interim outcome of considerable work developed by Working Part No 9 since 2010, with the active involvement of the business community and academic experts participating in the work of the Technical Advisory Group. While these are interim drafts at this stage, it will be extremely helpful to receive further input from the business community on these drafts. The following paragraphs provide further background information on each of the drafts.

2.1. Preface

This draft Preface presents the context of the Guidelines, their purpose and scope and their development process.

2.2. Core features of VATs covered by the Guidelines (Chapter I of the draft consolidated Guidelines)

This draft chapter is in substance a synthesis of the principles of VAT as generally accepted in OECD member countries and beyond. The function of this chapter is to identify those taxes to which the Guidelines apply and to set the scene for the Guidelines proper, i.e. it describes the concepts on which the Guidelines are based and the meaning of the words used to express such principles.

2.3. Determining the place of taxation for cross-border supplies of services and intangibles to businesses that have establishments in more than one jurisdiction (paragraphs 3.17 to 3.30 and 3.51 to 3.86) of the draft consolidated Guidelines

In 2010, the OECD released draft Guidelines on place of taxation for cross-border supplies of services and intangibles in a business-to-business ("B2B") context. These draft Guidelines set out key principles for identifying the place of taxation for supplies between businesses that are established in one jurisdiction only ("*single location entities*"). They did not deal with cross-border supplies to businesses that have establishments (e.g. that operate through branches) in more than one jurisdiction ("*multiple location entities*"). These cases are addressed by the draft that is now presented for public consultation.

The 2010 draft Guidelines started by confirming the destination principle, implying that the cross-border supply of a service or intangible will be free of VAT (i.e. exempt with right to deduct input tax) for the supplier in its own jurisdiction and that any VAT due on the transaction will be charged in the customer's jurisdiction. In a business-to-business context, the destination principle is generally implemented by identifying the place of taxation for internationally traded services and intangibles as the jurisdiction where the business use is deemed to occur. The 2010 draft Guidelines provided that the jurisdiction where the customer is located stands as the appropriate proxy for determining where the service or intangible is used in a business-to-business context. This is referred to in these Guidelines as the "*Main Rule*".

The draft Guidelines that are now presented for public consultation deal with cases where a cross-border supply of a service or intangible is made to a business that is established in more than one jurisdiction (a multiple location entity). An additional analysis is then required to determine which of the jurisdictions where this customer has establishments, is the place of taxation with respect to this supply. The draft Guidelines proposes that the place of taxation be the jurisdiction where the establishment that uses the service or intangible wholly or partially is located.

The draft Guidelines recognise that a service or intangible supplied to a multiple location entity may be acquired by one of its establishments for use by one or more of its other establishments located in different jurisdictions. Where this is the case, it is expected that the establishments using the externally acquired service or intangible will be charged for this service or intangible on the basis of internal arrangements within the multiple location entity. The draft Guidelines propose to use these internal recharges as a basis for allocating the taxing rights over such services or intangibles to the jurisdiction(s) where the establishment(s) of use is (are) located. This would be achieved by treating these internal recharges as internal supplies that are within the scope of VAT. The assessment of this “recharge method” by Working Party No 9 and by its Technical Advisory Group suggests that this method for determining the place of taxation builds on well-known and generally applied accounting and business processes and that it would not create undue administrative and compliance burden while offering appropriate evidence for revenue bodies.

An alternative approach considered by Working Party No 9 and its Technical Advisory Group is a “direct use method”, which would determine the place of taxation with respect to cross-border supplies of services or intangibles to multiple location entities by directly identifying the jurisdiction(s) of the customer’s establishment(s) that use(s) the service or intangible, including in cases where a service or intangible would be acquired by one establishment for use by one or more other establishments located in different jurisdictions. However, a preliminary assessment of this method suggests that it may create compliance difficulties for businesses, particularly where a service or intangible would be acquired by one establishment of a multiple location entity for use by other establishments of this entity. Particular areas of concern were the high amount of tax and accounting data that would need to be available in real time and the uncertainty around evidencing the location and extent of use of a service or intangible. These complexities may also affect the efficiency of tax administration and collection.

A further method considered by Working Party 9 and the Technical Advisory Group is determining the place of taxation based on where the customer’s head office is located. This would apply even where there is use at an establishment in another jurisdiction and irrespective of any recharge. This approach would be generally easier to implement and administer in practice and would ensure a high degree of certainty. However, it would take no account of the location where a service or intangible is used for the customer’s business operations. It would not realize the essential VAT neutrality objectives and it would fail on the objective of effective and fair tax treatment as it would create significant avoidance opportunities.

While the draft Guidelines do not propose either the direct use or head office methods as possible methods for determining the place of taxation with respect to cross-border supplies to multiple location entities at this instance, Working Party No 9 has not yet come to a final decision on what should be the recommended method and this is an area where further detailed public comment would be particularly useful for Working Party No 9 to reach a final conclusion.

For example, some jurisdictions may find it practical to combine the recharge method with the direct use method. This may be particularly the case where part of the supply being made to the multiple location entity is made directly to one or more of its establishments located in the supplier’s jurisdiction. In such instances, the direct use method may give rise to greater revenue certainty and easier administration, while the recharge method would be applied with respect to other supplies.

When reading the draft Guidelines on place of taxation for cross-border supplies of services and intangibles to multiple legal entities, it is important to bear in mind the following:

- These draft Guidelines only provide a recommended approach for identifying the place of taxation of services and intangibles that a multiple location entity acquires from an external supplier. As is the case for any other supply, it depends on a country's national legislation whether it will effectively wish to collect VAT (e.g. through methods like a reverse charge mechanism) on a recharged service or intangible for which it has the taxing rights.
- This draft deals only with the place of taxation with respect to services and intangibles that a multiple location entity acquires from an external supplier. It does not deal with internally generated or developed services or intangibles, or with value that is added internally to externally acquired services or intangibles; these cases remain outside the scope of these draft Guidelines.
- Underpinning these guidelines is the assumption that parties involved act in good faith and that all supplies are legitimate and with economic substance. Issues connected with tax evasion and avoidance will be addressed in the context of the development of anti-abuse provisions.

2.4. Implementation of specific rules for determining the place of taxation for cross border business-to business supplies (paragraphs 3.87 to 3.107 of the draft consolidated Guidelines).

The draft Guidelines recognise that determining the place of taxation with respect to cross-border supplies of services or intangibles between businesses on the basis of the customer's location may not give an appropriate tax result in every situation. Where this is the case, determining the place of taxation by reference to a proxy other than customer location may be justified. (e.g. supplier's location, place of performance, location of immovable property).

A rule that would determine the place of taxation by using a proxy other than the customer's location is referred to as a "*specific rule*" in the context of this draft. This draft sets out that any such specific rule should be supported by clear criteria and its use should be limited to the greatest extent possible. It then presents a general evaluation framework for assessing the desirability of a specific rule for determining the place of taxation and provides further guidance in particular on the possible application of a specific rule on place of taxation for supplies of services and intangibles directly connected with immovable property. This particular attention to services and intangibles connected with immovable property was considered appropriate as this is a particularly complex area where specific rules are already applied by many countries. In this context, a number of particular issues may require further work in the future. These may include scenarios where immovable property is located in more than one jurisdiction and situations where supplies of services and intangibles involving immovable property are performed in a chain of contracts (sub-contracting).

3. Public consultation process

Written comments can be provided by individuals or on a more collective basis by industry bodies or by professional advisory firms. Authors of comments and specific contributions are kindly requested to identify themselves, as we may need to follow-up with them on their responses. Unless otherwise requested at the time of submission, comments received will be posted on the OECD website.

Please send your written comments **by Friday 3 May 2013** in Word format by e-mail to Piet Battiau, Head of Consumption Taxes Unit, Centre for Tax Policy and Administration at piet.battiau@oecd.org.

This document is a draft consolidation of the OECD International VAT/GST Guidelines. It is structured according to the framework for the future International VAT/GST Guidelines approved by the Committee on Fiscal Affairs (CFA) on 26 June 2012. It includes:

- ***A Preface (approved by Working Party 9 on Consumption Taxes (WP9) for public consultation on 7 November 2012);***
- ***A Table of Contents (structure approved by WP9 for public consultation on 7 November 2012);***
- ***Chapter 1 - Core Features of Value Added Taxes Covered by the Guidelines (approved by WP9 for public consultation on 7 November 2012);***
- ***Chapter 2 - Neutrality of VAT in the Context of Cross-Border Trade (approved by WP9 and CFA in June 2011 - This Chapter includes the Commentary on the Guidelines on neutrality in international trade, which was approved by WP9 in November 2012 - paragraphs 2.24 to 2.73);***
- ***Chapter 3 - Applying the Destination Principle to Cross-Border Supplies of Services and Intangibles (Paragraphs 3.1. to 3.16 and 3.31 to 3.50 approved by the CFA for public consultation in January 2010; Paragraphs 3.17 to 3.30 and 3.51 to 3.107 approved by WP9 for public consultation in November 2012 before coming to any final conclusion on the recommended approach).***

Comments from the public are invited on those parts of the Guidelines that have not been issued for public consultation so far i.e. the Preface, Chapter 1 and Chapter 3 paragraphs 3.17 to 3.30 and 3.51 to 3.107.

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Public comments are invited on the draft Preface of the Guidelines below, setting out the context of the Guidelines, their purpose and scope and their development process.

PREFACE

1. As Value Added Taxes (VAT)[1] have continued to spread across the world, international trade in goods and services has likewise expanded rapidly in an increasingly globalised economy. One consequence of these developments has been the greater interaction between VAT systems, along with a growing risk of double taxation and unintended non-taxation in the absence of international VAT coordination.

2. Basic VAT principles are generally the same across countries insofar as they are designed to tax final consumption in the jurisdiction where it occurs according to the destination principle. Nevertheless, since the late 1990s tax authorities and the business community have recognised that VAT rules require greater coherence to avoid burdens on global trade. They have also recognised that a co-operative approach is required to solve common problems.

3. Building on the OECD Ottawa Conference on electronic commerce in 1998, the OECD's Committee on Fiscal Affairs (CFA) adopted the *Guidelines on Consumption Taxation of Cross-Border Services and Intangible Property in the Context of E-commerce* (2001), which were complemented by the *Consumption Tax Guidance Series* (2002).

4. Against the background of the strong growth of international trade in services, evidence grew that VAT could distort cross-border trade in services and intangibles more generally and that this situation was creating obstacles to business activity, hindering economic growth and distorting competition. The OECD considered these problems significant enough to require further remedies and it launched a project to develop *OECD International VAT/GST Guidelines* (the Guidelines) in 2006. The objective of the Guidelines is to address uncertainty and risks of double taxation and unintended non-taxation that result from inconsistencies in the application of these taxes to international trade, with a specific focus on trade in services and intangibles.

5. The Guidelines apply only to VAT systems, by whatever name or acronym they are known, that embody the basic features described in Chapter 1: broad-based taxes on final consumption collected from, but in principle not borne by, businesses through a staged collection process (by whatever approach, e.g. invoice credit method or subtraction method). Taxes that lack these characteristics in principle fall outside the scope of the Guidelines, even if they are denominated as a type of VAT. For example a "production-type VAT" would not be covered as such a tax is not designed to tax final consumption. The Guidelines also do not apply to single-stage consumption taxes charged only once to the end user at the final point of sale, such as retail sales taxes.

6. The Guidelines do not impose legally binding VAT rules on countries or provide draft detailed legislation. Rather, they are intended to provide a consistent set of principles for the VAT treatment of the most common types of international transactions. These principles are designed to provide guidance to countries in developing practical legislation that will facilitate a smooth interaction between national VAT

[1] For ease of reading, the terms "value added tax" and "VAT" are used to refer to any national tax that embodies the basic features of a value added tax as described in Chapter 1, by whatever name or acronym it is known (e.g. Goods and Services Tax (GST)).

regimes, with a view to minimising the potential for double taxation and unintended non-taxation and creating more certainty for business and tax authorities.

7. The Guidelines are being developed by the CFA, through its Working Party 9 on Consumption Taxes, in cooperation with a number of non-OECD economies and the Working Party's Technical Advisory Group (TAG), consisting of representatives from tax authorities and business and further supported by academics. The core features of the VAT, as described in Chapter 1, imply that businesses play an important role in the collection of the tax. Although they should not, in principle, bear the burden of the tax, businesses inevitably bear compliance costs associated with the collection of the tax from the final consumer and with the remittance to the tax authorities. Businesses are therefore considered key partners for governments in designing and operating VAT systems and the business community is actively involved in the development of the Guidelines.

8. The Guidelines are being developed in a staged process and the CFA regularly publishes interim drafts for public consultation. When the process of consultation is completed, all comments are carefully considered and the documents are reviewed as appropriate. Work then continues on the basis of the progress achieved. Each element that constitutes part of the Guidelines should be regarded as a building block and should not be considered in isolation. Each building block is reviewed over time in the light of the subsequent contributions to the Guidelines in order to form a coherent whole.

9. As a first step, it was agreed that the more pressing issues were the development of the core principles of VAT as applied to cross-border trade, i.e. the neutrality of the tax (see Chapter 2) and definition of the place of taxation for cross-border trade in services and intangibles[2] (see Chapter 3).

10. The CFA still intends to develop Guidelines on place of taxation for cross-border supplies of services and intangibles to final consumers ("B2C") as well as anti-abuse provisions and provisions on mutual cooperation and dispute resolution. The objective is to arrive at a complete set of Guidelines applying to cross-border trade in services and intangibles by the end of 2014. This work may be further expanded in the future, where this would prove appropriate.

[2] Some OECD countries have categories of supplies other than goods and services. For ease of reference, in these Guidelines items such as intellectual property rights and other intangibles are referred to as "intangibles".

Public comments are invited on the draft Chapter 1 of the Guidelines below, setting out the core features of VAT-systems to which the Guidelines are intended to apply

CHAPTER 1

CORE FEATURES OF VALUE ADDED TAXES COVERED BY THE GUIDELINES

1.1 Introduction

1.1 This chapter describes the core features of value added taxes (VATs)[3], with a particular focus on their application to international trade. The description is based on widely shared understandings among tax administrations, business enterprises and academic and other tax experts regarding the VAT's overall purpose, design, and implementation.

1.2 Overarching purpose of a VAT: a broad-based tax on final consumption

1.2 The overarching purpose of a VAT is to impose a broad-based tax on consumption, which is understood to mean final consumption by households. Accordingly, in principle only private individuals, as distinguished from businesses, consume within the meaning of a VAT. In practice, however, final consumers may include not only private individuals, but also various entities that are involved in non-business activities. As a broad-based tax, the VAT is distinguishable from excises targeted at specific forms of consumption such as the purchase of gasoline or alcohol.

1.3 A necessary corollary to the fundamental proposition that a VAT is a tax on final or household consumption is that the burden of the VAT should not rest on businesses. This corollary follows as a matter of elementary logic from the proposition that the VAT is a tax on household consumption, because businesses are not households and, at least as a matter of principle, are incapable of final or household consumption. In practice, if a business acquires goods or services that are used in whole or in part for the private consumption of the business owners, VAT regimes must determine whether, or the extent to which, the purchase should be treated as acquired for business purposes or for private consumption.

1.3 The central design feature of a VAT: staged collection process

1.4 The central design feature of a VAT, and the feature from which it derives its name, is that the tax is collected through a staged process. Each business in the supply chain takes part in the process of controlling and collecting the tax, remitting the proportion of tax corresponding to its margin, i.e. on the difference between the VAT paid out to suppliers and the VAT charged to customers. Thus, the tax is collected on the "value added" at each stage of production. In this respect, the VAT differs from a retail sales tax (RST), which taxes consumption through a single-stage levy imposed in theory only at the point of final sale.

1.5 The central design feature of the VAT – that tax be collected from businesses through a staged process – coupled with the fundamental principle that the burden of the tax does not rest on businesses requires a mechanism for relieving businesses of the burden of the VAT they pay when they acquire goods,

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[3] For ease of reading, the terms "value added tax" and "VAT" are used to refer to any national tax that embodies the basic features of a VAT as described in this chapter, by whatever name or acronym it is known (e.g. Goods and Services Tax (GST)).

services, or intangibles. There are two principal approaches for implementing the staged collection process while relieving businesses of the VAT burden, thus permitting successive taxpayers to deduct the VAT they pay on their purchases while accounting for the VAT they collect on their sales. Under the invoice credit method ("*transaction based method*"), each trader charges VAT at the specified rate on each sale and passes to the purchaser an invoice showing the amount of tax charged. The purchaser is in turn able to credit such payment of input tax against the output tax charged on its sales, remitting the balance to the tax authorities and receiving refunds when there are excess credits. Under the subtraction method ("*entity based method*"), the tax is levied directly on an accounts-based measure of value added, which is determined for each firm by subtracting VAT calculated on allowable purchases from VAT calculated on taxable sales. Almost all countries that operate a VAT use the invoice credit method.

1.6 In general, OECD countries with a VAT impose the tax at every stage of the economic process and allow deduction of taxes on purchases by all but the final consumer. This design feature gives to the VAT its essential character in domestic trade as an economically neutral tax.[4] The full right to deduct input tax through the supply chain, except by the final consumer, ensures the neutrality of the tax, whatever the nature of the product, the structure of the distribution chain and the technical means used for its delivery (retail stores, physical delivery, Internet). As a result of the staged payment system, VAT thereby "flows through the business" to tax the supplies to the final consumer.

1.4 VAT and international trade: the destination principle

1.7 The overarching purpose of the VAT as a levy on final consumption, coupled with its central design feature of a staged collection process, lays the foundation for the core VAT principles bearing on international trade. The fundamental issue of economic policy in relationship to the international application of the VAT is whether the levy should be imposed by the jurisdiction of origin or destination. Under the destination principle, tax is ultimately levied only on the final consumption that occurs within the taxing jurisdiction. Under the origin principle, the tax is levied in the various jurisdictions where the value was added. The key economic difference between the two principles is that the destination principle places all firms competing in a given jurisdiction on an even footing whereas the origin principle places consumers in different jurisdictions on an even footing.

1.8 The application of the destination principle in VAT achieves neutrality in international trade. Under the destination principle, exports are exempt with refund of input taxes (that is, free of VAT) and imports are taxed on the same basis and at the same rates as domestic supplies. Accordingly, the total tax paid in relation to a supply is determined by the rules applicable in the jurisdiction of its consumption and therefore all revenue accrues to the jurisdiction where the supply to the final consumer occurs.

1.9 By contrast, under the origin principle each jurisdiction would levy the VAT on the value created within its own borders.[5] Under an origin-based regime, exporting jurisdictions would tax exports on the same basis and at the same rate as domestic supplies, while importing jurisdictions would give a credit against their own VAT for the hypothetical tax that would have been paid at the importing jurisdiction's own rate. Tax paid on a supply would then reflect the pattern of its origins and the aggregate revenue would be distributed in that pattern. This would run counter to the core features of a VAT: as a tax on consumption, the revenue should accrue to the jurisdiction where the final consumption takes place. Under the origin principle, these revenues are shared amongst jurisdictions where value is added. Moreover, by imposing tax at the various rates applicable in the countries where value is added, the origin principle could influence the economic or geographical structure of the value chain and undermine neutrality in international trade.

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4 The neutrality of the VAT with respect to international trade is considered in Section 1.5 below.

5 This should be distinguished from the term used in the European Union for a proposed system (which was not implemented) in which the VAT would have been collected by the Member State of origin and the revenue later channelled to the Member State of destination for transactions within the European Union.

1.10 For these reasons, there is widespread consensus that the destination principle, with revenue accruing to the country of import where final consumption occurs, is preferable to the origin principle from both a theoretical and practical standpoint. In fact, the destination principle is the international norm and is sanctioned by World Trade Organization rules.[6]

1.5 VAT and international trade: implementing the destination principle

1.11 Because of the widespread acceptance of the destination principle for applying VAT to international trade, most of the rules currently in force are generally intended to tax supplies of goods, services and intangibles within the jurisdiction where consumption takes place. Practical means of implementing this intention are, nevertheless, diverse across countries, which can in some instances lead to double taxation or unintended non-taxation, and to uncertainties for both businesses and tax administrations.

1.12 Implementation of the destination principle with respect to international trade in goods is relatively straightforward in theory and generally effective in practice, due in large part to the existence of border controls or fiscal frontiers. Consequently, when the seller of goods is in one jurisdiction and the purchaser is in another, the goods are taxed where they are delivered. The exported goods are free of VAT in the seller's jurisdiction (and are freed of any residual VAT via successive businesses' deductions of input tax), whilst imports are subject to the same VAT as equivalent domestic goods in the purchaser's jurisdiction. The VAT on imports is generally collected at the same time as customs duties, although in some countries collection is postponed until declared on the importer's next VAT return. Allowing deduction of the VAT incurred at importation in the same way as input tax deduction on a domestic supply ensures neutrality and limits distortions in relation to international trade.

1.13 Implementing the destination principle with respect to international trade in services and intangibles is more difficult than with respect to international trade in goods. The nature of services and intangibles is such that customs controls are largely ineffective for confirming their exportation and their consequent right to be free of VAT in the country of export. Similarly, customs controls are largely ineffective for imposing VAT on services and intangibles as they cross the border upon importation. For these reasons, Guidelines have been developed for determining the jurisdiction of taxation for international supplies of services and intangibles that reflect the destination principle (see Chapter 3 of the Guidelines).

1.14 Making exports free of VAT, and taxing imports, introduces a breach in the staged collection process. In most countries where an invoice credit method is used, the VAT on cross-border business-to-business supplies of services and intangibles is usually collected by the reverse charge mechanism. This is a tax mechanism that switches the liability to pay the tax from the supplier to the customer. In the absence of such a mechanism, foreign suppliers that deliver services in countries where they are not established would in principle have to register for VAT purposes and fulfil all VAT obligations in that country. To avoid such administrative burdens on foreign providers, and to assure that VAT is accounted for, the reverse charge mechanism allows (or sometimes requires) the VAT-registered customer to account for the tax on supplies received from foreign traders. If the customer is entitled to full input tax credit in respect of the supply, it may be that local VAT legislation does not require the reverse-charge to be made. However, the reverse charge mechanism is not applied in all jurisdictions and, where it is implemented, the rules may differ from country to country.

[6] Footnote 1 of the Agreement on Subsidies and Countervailing Measures provides that *"…the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy.*"

1.6 Application of generally accepted principles of tax policy to VATs: the Ottawa Taxation Framework Conditions

1.15 Although they were articulated in the context of taxation of electronic commerce, the generally accepted principles of tax policy applicable to consumption taxes that were welcomed by Ministers from across the globe in 1998[7] are broadly applicable to VATs in both domestic and international trade. Indeed, the Ottawa Taxation Framework Conditions themselves derived from the "*same*" generally accepted tax policy "*principles that governments apply to conventional commerce*."[8] These principles, some of which have already been noted above, may be summarised as follows:

- ***Neutrality:*** Taxation should seek to be neutral between forms of commerce, between businesses in similar situations carrying out similar transactions, between foreign and domestic businesses, and between international and domestic trade.
- ***Efficiency:*** Compliance costs for businesses and administrative costs for the tax authorities should be minimised as far as possible.
- ***Certainty and simplicity:*** Tax rules should be clear and simple to understand so that businesses can anticipate the tax consequences of a transaction, including knowing when, where, and how the tax is to be determined and reported.
- ***Effectiveness and fairness:*** Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved.
- ***Flexibility:*** The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

[7] The Ottawa Taxation Framework Conditions were welcomed by Ministers from the 29 member countries and 11 non-member economies at the Ministerial Conference on Electronic Commerce held in Ottawa on 7 - 9 October 1998.

[8] OECD, *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* 10 (2001) (emphasis in original).

CHAPTER 2

NEUTRALITY OF VALUE ADDED TAXES
IN THE CONTEXT OF CROSS-BORDER TRADE

2.1 Introduction

2.1 The concept of tax neutrality in VAT has a number of dimensions, including the absence of discrimination in a tax environment that is unbiased and impartial and the elimination of undue tax burdens and disproportionate or inappropriate compliance costs for businesses. Neutrality is one of the principles that help to ensure the collection of the right amount of revenue by governments.

2.2 These Guidelines are concerned with all aspects of neutrality in the international context. Although they draw from the basic principles that apply to domestic transactions, they do not cover domestic aspects of neutrality, such as the influence of the tax structure (e.g. different rates and exemptions) on consumption decisions by consumers.

2.2 Basic neutrality principles

2.3 The basic principles underpinning neutrality are set out in Chapter 1. In domestic trade, tax neutrality is achieved by the staged payment system: each business pays VAT to its providers on its inputs and receives VAT from its customers on its outputs. To ensure that the "right" amount of tax is remitted[9] to tax authorities, input VAT incurred by each business is offset against output VAT, resulting in a liability to pay the net amount or balance of those two. This means that VAT normally "flows through the business" to tax the final consumers. It is therefore important that at each stage, the supplier be entitled to a full right to deduction of input tax, so that the tax burden eventually rests on the final consumer rather than on the intermediaries in the supply chain. This principle is laid down in Guideline 2.1.

Guideline 2.1

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

2.4 In this context, the words *"except where explicitly provided"* mean that countries may legitimately place a value added tax burden on business. Indeed, this is frequently the case as the following examples illustrate:

- Where transactions made by businesses are exempt because the tax base of the outputs is difficult to assess (i.e. many financial services) or for policy reasons (health care, education, culture);

- Tax legislation may also impose value added tax on businesses to secure effective taxation of final consumption. This will be the case when the business makes transactions that fall outside the scope of the tax (e.g. transactions without consideration) or the input tax relates to purchases that are not wholly used for furtherance of taxable business activity;

[9] In some cases, the result of the offset gives rise to a refund due by the tax authorities to the business. Examples include businesses that incur more tax on their inputs than is due on their outputs (such as exporters, whose output is free of VAT under the destination principle) and businesses whose purchases are larger than their sales in the same period (such as new or developing businesses and seasonal businesses).

- Countries also provide legislation that disallows input tax recovery where explicit administrative obligations are not met (e.g. insufficient evidence to support input tax deduction).

2.5 Any such imposition of VAT on business should be clear and explicit within the legislative framework for the tax.

Guideline 2.2

Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation.

2.6 The tax should be neutral and equitable in similar circumstances. This is to ensure that the tax ultimately collected along a particular supply chain is proportional to the amount paid by the final consumer, whatever the nature of the supply, the structure of the distribution chain, the number of transactions or economic operators involved and the technical means used.

Guideline 2.3

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

2.7 It is recognised that there are, in fact, a number of factors that can influence business decisions, including financial, commercial, social, environmental and legal factors. Whilst VAT is also a factor that is likely to be considered, it should not be the primary driver for business decisions. For example, VAT rules or policies should not induce businesses to adopt specific legal forms under which they operate (e.g. whether in a subsidiary or a branch structure).

2.8 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.

2.9 In addition, to support the neutrality principle, the VAT rules should be accessible, clear and consistent.

2.3 Neutrality in international trade

2.3.1 Taxation principles

2.10 The general principles underpinning neutrality described above and the Guidelines that flow from them apply equally to domestic and international trade. The question is whether there are any additional considerations that need to be taken into account in the international context.

2.11 It is particularly important that the application of the rules for international supplies does not produce a tax advantage for comparable domestic transactions. This includes the level at which taxation is applied, the costs of collection and administration and the corresponding burdens placed on businesses and tax administrations.

Guideline 2.4

With respect to the level of taxation, foreign businesses should not be disadvantaged nor advantaged compared to domestic businesses in the jurisdiction where the tax may be due or paid.

2.12 VAT systems are designed to apply in a fair and even-handed way to ensure there is no unfair competitive advantage afforded to domestic businesses that may otherwise discourage international trade and limit consumer choice. This is achieved by the application of the destination principle (exports are free of VAT and imports are taxed on the same basis and at the same rate as local production), which ensures that the tax levied on imports does not exceed the tax levied on the same supplies in the domestic market. In addition, it also ensures that the amount of tax which is refunded or credited in the case of exports is equal to the amount of tax that has been levied.

2.13 The embedded features of the VAT system combined with the destination principle should ensure the same neutrality for international trade. However, there are in practice a number of cases where the standard rules will not apply and foreign businesses will incur VAT in a jurisdiction where they are neither established nor registered. Normally, the right to deduction of VAT is exercised by reducing the net tax payable. However, when foreign businesses incur VAT on business expenditures in a jurisdiction where they are not registered (or required to be registered) for VAT, this process cannot be applied.

2.14 Application of the principle that VAT should be neutral and equitable in similar circumstances to international trade implies that the VAT system should not encourage or discourage businesses from investing in or undertaking activities in a specific country. Such business decisions should be made on the basis of market and other non-tax considerations. This means that legislation in place in the country where VAT is incurred by foreign businesses should not discriminate against them as regards the imposition of tax and their right to deduction or recovery of VAT compared to domestic businesses. Some tax administrations may make reference to reciprocity when setting norms for refunds or equivalent mechanisms.

Guideline 2.5

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

2.15 The basic principles of VAT are broadly the same across countries that impose VAT, in that they aim to tax consumption in the jurisdiction where it occurs. However, differences exist between them as to the means used to achieve this as a result of many things, including local history and traditions and the need to achieve specific policy objectives. This includes the approach countries take to ensure neutrality of taxation in respect of foreign businesses.

2.16 The approaches adopted by countries to ensure the principle that foreign businesses should not incur irrecoverable VAT include:

- The operation of a system of applying for direct refunds of local VAT incurred;
- Making supplies free of VAT;
- Enabling refunds through local VAT registration;
- Shifting the responsibility on to locally registered suppliers/customers; and
- Granting purchase exemption certificates.

2.17 Some countries may adopt only one approach, but others use a combination of different approaches

2.18 Each approach seeks to ensure that foreign businesses do not incur irrecoverable VAT. As a result, none of the approaches is to be preferred as a general rule. It is likely that each approach will have its merits in particular circumstances, as each seeks to strike a balance between the relative compliance costs for businesses (both local supplier and foreign customer), on the one hand and administrative costs and the risks of tax fraud and avoidance for the tax authorities, on the other hand. The key is to find a reasonable balance between the two, while ensuring that, to the greatest extent possible, foreign businesses do not incur irrecoverable VAT, except where explicitly provided for in legislation on a basis that does not allow unjustified discrimination.[10]

2.3.2 Administration and compliance

2.19 As with many other taxes, VAT imposes compliance costs and burdens on businesses and administrative costs and burdens on the tax authorities. Examples of costs associated with VAT compliance include costs related to administration (e.g. employees and the costs of collection and recovery), infrastructure (e.g. costs associated with establishing systems and processes, including making software changes) and finance (e.g. cash-flow costs and the costs of bank guarantees).

2.20 Paragraph 2.7 outlines the principle that VAT considerations should not be the primary driver for business decisions. Paragraph 2.8 recognises that VAT considerations go beyond the amount of tax ultimately paid to tax administrations and include the associated costs.

2.21 The principle that businesses should not incur irrecoverable VAT (except in the circumstances contemplated by paragraph 2.4) does not mean that compliance costs and burdens should not be borne by businesses. Similarly, tax administrations will incur costs and burdens in managing VAT systems, including the underlying procedures and policies. Although some form of VAT refund or relief mechanism should generally be available to foreign businesses, the availability and scope of such systems or mechanisms must take into account the related burdens of administration, collection and enforcement. For example, they should not involve disproportionate costs or burdens on the tax administration, such as might be the case when dealing with frequent low value or *de minimis* claims.

Guideline 2.6

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

2.22 It may be appropriate for tax administrations to impose specific compliance requirements on different categories of businesses. This may apply, for example, to small enterprises and enterprises in specific sectors. It may also apply to foreign businesses. Indeed, dealing with foreign businesses with no "legal" presence in a jurisdiction inevitably brings an element of risk for tax administrations and they may need to take appropriate measures to protect against fraud or avoidance. However, tax administrations are encouraged to take full advantage of available instruments that support exchange of information and mutual assistance in debt recovery (e.g. the Multilateral Convention on Mutual Administrative Assistance in Tax Matters).

2.23 Tax administrations should also seek to balance these appropriate measures with the need to prevent unjustified discrimination. In other words, specific rules applicable to foreign businesses should not result in a disguised form of discrimination. It is also important that such specific requirements are clear, consistent and accessible to foreign businesses.

[10] Article 24 of the OECD Model Tax Convention on Income and on Capital and its commentary provide principles, examples and reflections on the concept of non-discrimination.

2.4 Applying the VAT neutrality principles in the context of cross-border trade: Commentary on the Guidelines

2.24 Guideline 2.1 provides that businesses should in principle not bear the burden of VAT itself. In cross-border trade VAT neutrality is achieved relatively simply through the application of the destination principle in accordance with Guideline 3.2 when the business customer that receives an imported service or intangible has a full right to deduct the input tax. In addition, even when the right to deduction of the business customer is limited, if that limitation is the same for imported services and intangibles as it would be for domestic supplies, neutrality may also be achieved.

2.25 However, it is recognised that the application of the destination principle in accordance with Guideline 3.2 will not be possible in all situations. Under certain conditions, some supplies could be taxed in a jurisdiction other than that where the business customer is located. As a result, the foreign business customer may incur VAT in jurisdictions where it cannot recover the input tax by way of deduction through the same procedures as domestic businesses. In such situations, alternative ways of ensuring neutrality should be available.

2.26 The overall neutrality of VAT on cross-border trade would be ensured by the application of the destination principle in accordance with Guideline 3.2 to the widest extent possible and a consistent use of a limited number of specific place of taxation rules, together with a range of adequate relief mechanisms. However, in some instances, differences in the way two or more countries interpret place of taxation rules may create situations where neutrality is not achieved. This may also happen when businesses with no or limited right of deduction are involved. Further work may be needed to address such situations.

2.27 The aim of this Commentary is to provide guidance for the implementation of the Guidelines on neutrality in practice.

2.28 For each guideline, there is a specific commentary that is intended to illustrate or provide further details on, but not change, its provisions.

2.4.1 Principles of good tax administration

2.29 The Guidelines on neutrality are not intended to interfere with the sovereignty of jurisdictions to apply tax rules for limiting the right to deduct input VAT, to exempt particular activities or to establish specific administrative requirements for dealing with different categories of business (including foreign businesses). However, in order to ensure neutrality, governments are encouraged to apply the General Administrative Principles approved in 2001 by the OECD Forum on Tax Administration[11] (*GAP001 Principles of Good Tax Administration – Practice Note)*, which are reproduced in Box 2.1 below.

Box 2.1

1. Guidance - Relations with Taxpayers - Revenue authorities *are encouraged to*:

1.1 apply tax laws in a fair, reliable and transparent manner;

1.2 outline and communicate to taxpayers their rights and obligations as well as the available complaint procedures and redress mechanisms;

1.3 consistently deliver quality information and treat inquiries, requests and appeals from taxpayers in an accurate and timely fashion;

1.4 provide an accessible and dependable information service on taxpayers rights and obligations with respect to the law;

[11] http://www.oecd.org/dataoecd/34/39/1907918.pdf

1.5	ensure that compliance costs are kept at the minimum level necessary to achieve compliance with the tax laws;
1.6	where appropriate, give taxpayers opportunities to comment on changes to administrative policies and procedures;
1.7	use taxpayer information only to the extent permitted by law;
1.8	develop and maintain good working relationships with client groups and the wider community.

2.4.2 Reciprocity

2.30 According to the Guidelines on neutrality, foreign businesses should not be disadvantaged or advantaged compared to domestic businesses. This notably means that foreign businesses should not incur irrecoverable VAT when this would constitute an unjustified discrimination compared to domestic businesses. A number of approaches could be used for this purpose such as direct refunds to foreign businesses, refunds through a domestic registration procedure or making supplies VAT-free.

2.31 Some jurisdictions[12] require that the granting of refunds to foreign businesses be conditional upon similar relief being granted by the jurisdiction of the foreign business claimant. These requirements for reciprocity generally take two forms: a formal bilateral agreement between jurisdictions or a unilateral decision to recognise jurisdictions considered as having (or not having) appropriate features in their legislation.[13]

2.32 The Guidelines take no position on the desirability of jurisdictions adopting reciprocity requirements. However, insofar as jurisdictions choose to adopt such requirements, they should do so in a manner that minimises their impact on neutrality.

2.33 It is important to consider the scope of the reciprocity requirements. Indeed, in the context of the Guidelines, a reciprocal mechanism would not be required from a jurisdiction that does not have a VAT system, as defined for purposes of these Guidelines.[14] Jurisdictions are encouraged to treat other jurisdictions' mechanisms designed to ensure VAT-neutral treatment for foreign businesses as satisfying reciprocity requirements where these mechanisms achieve a substantially equivalent treatment. A substantially equivalent treatment might, for example, result from a mixture of VAT-free supply and local registration mechanisms as much as the application of a direct refund approach.[15]

2.4.3 Groups of countries

2.34 Based on the principle set out in the *Guidelines on Consumption Taxation of Cross-Border Services and Intangible Property* (in the context of e-commerce) and in accordance with the Ottawa Taxation Framework Conditions, a group of countries bound by a common legal framework for their VAT system may apply specific measures to transactions between those countries. If this gives rise to a difference of treatment between member countries of such a group and non-member countries, but the

[12] These include countries within the European Union, as well as other countries.

[13] Reciprocity is currently applied by some countries that operate "direct refund mechanisms" (i.e. refunds through a stand-alone procedure, rather than through a local registration). However, it is possible that it may be applied in a wider sense, in which case the same guidance in this commentary can also be applied**.**

[14] See Chapter 1. Where a jurisdiction operates a hybrid system, the part of the system that is not a VAT would not be considered.

[15] Germany has expressed a reservation on this paragraph.

treatment of non-member countries would not otherwise be inconsistent with the Guidelines on neutrality, the difference should not be regarded as being inconsistent with these Guidelines.

2.4.4 Commentary on Guideline 2.1

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

2.35 VAT normally flows through businesses so that the final consumer, not the business, bears the burden of the tax. In domestic trade, VAT neutrality is achieved by the staged payment system: each business pays VAT to its suppliers on its inputs and receives VAT from its customers on its outputs. Input VAT incurred by each business is offset against output VAT so that the amount of tax to be remitted to tax authorities by each business is the net amount or balance of those two. In some cases, the result of the offset gives rise to a refund due by the tax authorities to the business. Examples include businesses that incur more tax on their inputs than is due on their outputs (such as exporters, as their output is free of VAT under the destination principle) and businesses whose purchases are larger than their sales in the same period (such as with new or developing businesses or seasonal businesses).

2.36 In cross-border trade, the neutrality of the tax is achieved by the application of the destination principle. According to this principle, exports are not subject to tax (free of VAT) and imports are taxed on the same basis and at the same rates as domestic supplies. This implies that the total tax paid in relation to a supply is ultimately determined by the rules applicable in the jurisdiction of its consumption and therefore all revenue accrues to the jurisdiction where the supply to the final customer occurs. In some instances, however, foreign businesses may incur VAT in jurisdictions where they cannot recover the input tax by way of deduction through the same procedures as domestic businesses (see paragraph 2.25 above). As in the case of domestic businesses, foreign businesses should not bear the burden of the tax itself, except where provided for in legislation.

2.37 Although the burden of VAT should not fall on businesses, Guideline 2.1 recognises that governments may legitimately place a VAT burden on them when this is specifically set out in legislation. Guideline 2.1 and this corresponding Commentary do not seek to make any judgment about the circumstances in which it may or may not be appropriate to place a VAT burden on businesses. They simply recognise that governments may do so.

2.38 Guideline 2.1 is not intended to interfere with the sovereignty of jurisdictions to apply rules for limiting or blocking the right to deduct input VAT. However, in order to ensure neutrality, in applying such rules, tax administrations are encouraged to apply the principle of good tax administration as set out in Box 2.1

2.39 When governments do impose a VAT burden on businesses, in accordance with Box 2.1 legislation that so provides should be clear and transparent and should keep compliance costs to a minimum.

2.40 The reference to explicit provision in the legislation in Guideline 2.1 is not limited to provisions of the law itself but also includes explicit provision made under the law, such as in regulations or as a result of the exercise of administrative powers granted by the legislation. Decisions of courts of the relevant jurisdiction should also be taken into consideration.

2.41 When a tax burden is placed on businesses, the explicit provision for such burden in legislation does not suffice to make it consistent with the Guidelines on neutrality. It simply means that Guideline 2.1 is met. If the legislation in question does not meet the other five Guidelines on neutrality, or is inconsistent with the Guidelines as a whole, such legislation cannot be seen as meeting the neutrality principles.

2.4.5 Commentary on Guideline 2.2

Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation.

2.42 The main goal of Guideline 2.2 is to ensure that "*similar levels of taxation*" are achieved. However, the goal is recognised only with respect to "*businesses in similar situations*" that are carrying out "*similar transactions*". If either one of these conditions is not satisfied, Guideline 2.2 has no application. Accordingly, in explaining the meaning of the Guideline, it is essential to separate the concepts of "*businesses in similar situations*" and "*similar transactions*."

Similar levels of taxation

2.43 In the context of the Guidelines on neutrality, when determining whether a "*similar level of taxation*" has been achieved, the final tax burden needs to be considered, taking into account all available refunds and credits. Businesses with full right to deduct input tax should not bear any tax burden, whether the services and intangibles they use to make their onward supplies are acquired abroad or in the domestic market. When a business without full right to deduct input tax incurs VAT in different jurisdictions, it should bear the burden of the VAT only once on each input. If such a business were to incur irrecoverable tax in two or more jurisdictions on the same input, it would not bear a "*similar level of taxation*" compared to another business without full right to deduct input tax that acquired its inputs solely within the domestic market.

2.44 Guideline 2.2 applies only to the VAT burden directly incurred by businesses. Guideline 2.2 does not cover situations where businesses indirectly incur a positive level of taxation, for example, where they acquire exempt services for which the supplier did not have a right to deduct its own input tax. In this case, the price paid by the business customer to its supplier may include embedded VAT that the supplier is unable to recover.

Businesses in similar situations

2.45 Determining whether businesses are in "*similar situations*" should be assessed with respect to their right of deduction, determined by the extent to which their inputs are used to support taxable activities (which give rise to the right to deduct the related input tax). A business that is acquiring services to support its taxable activities would not be in a "*similar situation*" to a business acquiring services to support its exempt activities or to one that acquires services predominantly for the personal use of its owners. A "*similar situation*" should not be restricted to a comparison of similar industries.

2.46 The following are examples of businesses in similar situations, which are based on their right of deduction:

- A consulting company with a full right to deduct input tax in comparison to an airline company with a full right to deduct input tax.
- A bank that has a limited right to deduct input tax in comparison to an insurance company that has a limited right to deduct input tax.
- A consulting company with a full right to deduct input tax in comparison to a bank that also has a full right to deduct input tax (e.g. because its outputs are fully taxed or zero-rated).
- A business with a limited right to deduct input tax, which acquires services for the private use of its owners, in comparison to a business that normally has a full right to deduct input tax and has acquired services for the private use of its owners.

2.47 The following are examples of businesses in dissimilar situations:

- A consulting company with a full right to deduct input tax in comparison to a bank that has a limited right to deduct input tax.
- A financial institution with a full right of deduction (e.g. because its outputs are fully taxed or zero-rated) in comparison to a financial institution that has a limited right of deduction (e.g. because it provides exempt financial services to domestic customers).
- A business which normally has a full right to deduct input tax, and acquires services for the private use of its owners, in comparison to a business with a full right to deduct input tax which acquires services for use in its taxable activities.

Similar transactions

2.48 The determination of "*similar transactions*" for businesses "*in similar situations*" purchasing services or intangibles should focus on the characterisation of the particular services or intangibles being supplied. The way the supply is made, the person from whom it was acquired within the supply chain, or the terms under which the services or intangibles were acquired should not be relevant to this determination.

2.49 The characterisation of a supply may not be consistent across jurisdictions. For example some jurisdictions may apply a specific tax treatment to a number of well defined services or intangibles while other jurisdictions have a single characterisation of services and then a single tax treatment for their supply. For that reason it is important to consider the characterisation of the supply under the rules in the jurisdiction in which businesses are being compared.

Summary

2.50 To summarise, the following factors are to be considered in determining when situations, transactions, and tax burdens, respectively, are similar.

- Businesses are in similar situations based on their use of the services or intangibles and their related right to deduct input tax (i.e. the supply is used to further taxable activities, exempt activities or is for personal use - which will determine the right to deduct input tax).
- Businesses are carrying out similar transactions based on the characterisation of the supply under the rules in the jurisdiction in which the businesses are being compared.
- Business incur similar levels of taxation when they do not incur a tax burden, or when they do directly incur irrecoverable VAT, it is incurred only once on the same supply, and that would also be the case for a business in a similar situation.

2.4.6 Commentary on Guideline 2.3

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

2.51 Inconsistency with Guideline 2.3 relating to the impact of VAT on business decisions is likely to reflect an inconsistency with one of the other Guidelines. Where this is the case, businesses may try to restructure their supply chain or operations to achieve the neutrality that does not otherwise exist. In the context of Guideline 2.3, VAT considerations include a combination of the amount of tax ultimately paid to tax administrations, the associated compliance burdens and the financial costs related to the cash-flow impact of the VAT system.

2.52 For example, in situations where foreign businesses are advantaged compared to domestic businesses, in respect of the level of taxation (which is inconsistent with Guideline 2.4), a foreign business may change the decision it would otherwise make primarily to take advantage of this treatment. Thus, a business may decide to operate from offshore rather than in the domestic jurisdiction.

2.53 When evaluating a jurisdiction where a domestic business can fully recover local VAT, a foreign business that would not be eligible for VAT recovery, refund or relief may decide, primarily based on the VAT burden, that it will not undertake activities (sales, purchases, or related activities such as production or support services) in that jurisdiction or that it has to restructure the supply chain to achieve the neutrality that does not otherwise exist.

2.54 In order to assess the consistency of the VAT rules with Guideline 2.3, the business decisions that are relevant would be those relating to cross-border operations, which may be affected by the VAT legislation, such as:

- whether a business will decide to operate in a jurisdiction;
- whether a business will sell to customers in a jurisdiction;
- whether a business will make purchases from a vendor located in a jurisdiction;
- whether a business outsources activities such as production, manufacturing or other support services to be carried out in a jurisdiction, and
- how a business structures its supply chain or makes use of intermediaries.

2.55 By contrast, business decisions that are not relevant would be those relating to the domestic operations, such as:

- decisions not to purchase or sell items on which there is a block on input tax credits (e.g. in some jurisdictions there is a difference between leased and purchased items);
- altering products or services to take advantage of a different tax status (e.g. taxable at a positive rate, exempt or zero-rated); and
- taking advantage of simplified methods of calculating taxes due, which may be available to smaller suppliers.

2.4.7 Commentary on Guideline 2.4

With respect to the level of taxation, foreign businesses should not be disadvantaged nor advantaged compared to domestic businesses in the jurisdiction where the tax may be due or paid.

2.56 Guideline 2.2 deals with equity of treatment for businesses in similar situations carrying out similar transactions. Guideline 2.4 deals with equity of treatment for foreign businesses relative to domestic businesses in a jurisdiction where foreign businesses may otherwise bear a VAT burden, which would not apply to domestic businesses or vice-versa.

2.57 In the context of the Guidelines and with respect to the level of VAT incurred, *"foreign businesses should not be disadvantaged nor advantaged compared to domestic businesses in the jurisdiction where the tax may be due or paid*" should be understood to mean that:

- There should not be any discriminatory application of the rules simply because a business is foreign;
- Foreign businesses should not end up having a tax advantage compared to domestic businesses in terms of their final tax burden; and

- If Guideline 2.4 is followed, VAT should not distort competition between foreign and domestic businesses. [16]

2.58 This Guideline deals with the ultimate application of VAT on businesses. Foreign businesses should not be subject to irrecoverable VAT compared to domestic businesses, however that outcome is achieved, e.g. through application of zero-rate rules, refund mechanisms, etc. Nor would the creation of a tax advantage, in terms of the final tax burden, for foreign businesses compared to domestic businesses acting in similar circumstances be consistent with this Guideline. When legislation provides a refund or other form of relief mechanism to foreign businesses, in such a way that they are not advantaged or disadvantaged compared to domestic businesses, Guideline 2.4 is met.

2.4.8 Commentary on Guideline 2.5

To ensure foreign businesses do not incur irrecoverable VAT, governments may choose from a number of approaches

2.59 A range of approaches could be used to ensure that foreign businesses do not incur irrecoverable VAT. These include (but are not limited to):

- 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 the responsibility to locally registered suppliers/customers[17]; and
- granting purchase exemption certificates.[18]

2.60 Each approach seeks to ensure that foreign businesses do not incur irrecoverable VAT. None of the approaches is to be preferred over the others. It is likely that each approach will have its merits in particular circumstances, as each seeks to strike a balance between the relative compliance costs for businesses (both local supplier and foreign customer), on the one hand, and administrative costs and the risks of tax fraud and avoidance for the tax authorities, on the other. Countries may prefer to apply a mix of different approaches depending on the nature of the supplies involved. For example, for some supplies, making supplies VAT free may be preferred to direct refunds or registration because it removes the compliance costs for businesses of having to claim the VAT back. For other supplies, a refund or registration system may be preferred because of the difficulty faced by the supplier in determining the status and location of the customer.

2.61 Governments will seek to protect their tax bases from fraud and to use all reasonable methods to achieve this objective. However, cost effectiveness is important to any mechanism for achieving neutrality, including any refund and similar schemes. Measures taken by a government to protect its tax base may

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[16] Germany has expressed a reservation on this paragraph.

[17] Some countries provide for a shift in responsibilities to allow either a) a purchaser to claim input tax that was charged to a non-resident vendor who is not registered for local VAT, or b) services to be provided on a VAT-free basis to a non-resident who is not registered, even though the services may closely relate to property that is located in the local country, when the property to which the services relates will subsequently be delivered to a registrant in the local country.

[18] Some countries allow a non-resident purchaser who may or may not be registered locally to provide a purchase exemption certificate to allow the supplier to make a supply on a VAT-free basis. The supplier would be responsible for retaining a copy of the purchase exemption certificate on file to substantiate why tax was not charged to the non-resident.

therefore need to be balanced against the objective of keeping compliance and administration costs as low as possible.

2.62 For example, a direct refund system that applies a *de minimis* threshold before refund applications are accepted would meet the neutrality objective provided that the threshold is reasonable and reflects the balance between the administration costs of processing the refund and the amount of VAT involved. On the other hand, a registration system that does not allow refunds unless taxable supplies are made in the local jurisdiction by the non-resident business may not adequately meet the neutrality objective.

2.4.9 Commentary on Guideline 2.6

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

2.63 Domestic businesses and foreign businesses are in different situations in relation to the tax administration. Domestic businesses will generally have a fixed place of business from which the business is operated, local employees and contact persons, a local bank, local links to the tax authorities and various forms of identification/registration through bodies such as local Chamber of Commerce and Trade Registry. On the other hand, foreign businesses are less likely to have a legal presence, local staff or links with the local community.

2.64 It is this lack of presence and history in a jurisdiction that inevitably brings an element of risk for tax administrations, for which appropriate measures may need to be taken to protect against fraud and avoidance. Specific compliance requirements may therefore be needed if the standard requirements applicable to domestic businesses do not provide adequate protection for governments. Tax administrations are also encouraged to take full advantage of available instruments that support exchange of information and mutual assistance in debt recovery (e.g. the Multilateral Convention on Mutual Administrative Assistance in Tax Matters).

2.65 In addition, where jurisdictions operate a relief mechanism specifically aimed at foreign businesses, they may also have specific rules and requirements for that mechanism.

2.66 The Guidelines on neutrality recognise that the administrative requirements for domestic and foreign businesses may not be identical. However, if jurisdictions choose to adopt specific rules and requirements on foreign businesses, they should do so in a manner that minimises their impact on neutrality.

2.67 In essence, where there is an element of additional compliance burden associated with doing business in a foreign jurisdiction, the burden created by the specific administrative requirements should not be disproportionate or inappropriate.

2.68 A requirement or combination of requirements may be disproportionate or inappropriate when it is out of proportion with the situation to which it relates or does not achieve a relevant purpose when assessed and measured against the objective it is aiming to achieve. In other words, in the context of the Guidelines, such a requirement or combination of requirements should not be disproportionate or inappropriate to any additional risk involved in dealing with a foreign business.

2.69 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 or practices (e.g. audits, time taken to provide a refund) applicable to foreign businesses should not result in a disguised form of discrimination and should also meet the guiding principles set out in paragraph 2.29.

2.70 For example, if a tax administration requires a bank guarantee, the amount and duration should not be disproportionate to the amount claimed. Similarly, when documentation is required to support a refund claim (possibly in the language of the country where the claim is lodged), it should be limited to the documents that are necessary to the assessment of the validity of the claim. In addition, the time taken to make a refund and the resulting cash-flow burden should be taken into account.

2.71 Tax administrations will also incur administrative costs in managing specific relief mechanisms aimed at foreign businesses (e.g. a refund mechanism). When they set up *de minimis* thresholds, they should not effectively prevent the use of the mechanism.

2.72 Whilst the concept of specific administrative requirements for foreign businesses is generally understood to mean additional and more complex requirements, it is not always the case. In some instances, tax administrations can set up a simplified compliance system specifically for foreign businesses. Examples include specific zero-rating provisions applicable to supplies to foreign businesses, as well as simplified registration and reporting procedures for foreign businesses.

2.73 Finally, specific administrative requirements or simplifications adopted by a group of countries that is bound by a common legal framework for their consumption tax systems may differ from those applicable to businesses from other countries. As expressed in paragraph 2.34 such a difference of treatment should not be regarded as being inconsistent with Guideline 2.6.

In this Chapter, public comments are invited on:

- **the draft Guidelines on place of taxation for cross-border supplies of services and intangibles to <u>businesses that have establishments in more than one jurisdiction</u>, as set out in paragraphs 3.17 to 3.30 and in paragraphs 3.51 to 3.86;**
- **the draft Guidelines on the implementation of <u>specific rules</u> for determining the place of taxation for cross border business-to-business supplies of services and intangibles, as set out in paragraphs 3.87 to 3.107.**

Underpinning this work is the assumption that parties involved act in good faith and that all supplies are legitimate and with economic substance. Issues connected with tax evasion and avoidance will be addressed as part of future work

CHAPTER 3

DETERMINING THE PLACE OF TAXATION FOR CROSS-BORDER SUPPLIES OF SERVICES AND INTANGIBLES

3.1 Introduction

3.1 As explained in Chapter 1, VAT neutrality in international trade is generally achieved by use of the "*destination principle*". Implementing the destination principle with respect to international trade in goods is relatively straightforward in theory and generally effective in practice, due in large part to the existence of border controls or fiscal frontiers.

3.2 Implementing the destination principle with respect to international trade in services and intangibles is more difficult than with respect to international trade in goods. The nature of services and intangibles is such that customs controls are largely ineffective for confirming their exportation and their consequent right to be free of VAT in the country of export. Similarly, customs controls are largely ineffective for imposing VAT on services and intangibles as they cross the border upon importation. For these reasons, Guidelines have been developed for determining the jurisdiction of taxation for international supplies of services and intangibles that reflect the destination principle while ensuring that:

- international neutrality is maintained;
- compliance by businesses involved in these supplies is kept as simple as possible;
- clarity and certainty are provided for both business and tax administrations;
- the costs involved in compliance and administering the tax are minimal; and
- barriers to fraud and other abuses are sufficiently robust.

3.3 In applying the destination principle, it may be necessary in certain circumstances to apply different approaches to international supplies from business to business[19] than to international supplies

[19] For the purposes of these Guidelines "*business-to-business supplies*" should be understood as supplies where both supplier and customer are entities (either legal or natural persons) that are recognised as "*businesses*" for VAT purposes in national law.

from business to consumers. These Guidelines therefore provide separate consideration for the business-to-business and business-to-consumer context.

3.2 Destination principle

Guideline 3.1

For consumption tax purposes internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption.

3.4 The principle set out in Guideline 3.1 is generally denominated the "*destination principle*". As explained in Chapter 1, it is designed to ensure that tax on services and intangibles traded internationally[20], is ultimately levied only on the final consumption that occurs within the taxing jurisdiction and thereby to maintain neutrality within the VAT system as it applies to international trade. Although the destination principle's fundamental purpose is to ensure that all revenue accrues to the jurisdiction where the supply to the final consumer occurs, the principle is not limited to business-to-consumer supplies.[21] It likewise applies to business-to-business supplies, even though business-to-business supplies do not involve final consumption.[22] Because internationally traded business-to-business supplies are taxed in conjunction with the VAT's staged collection process, the destination principle (under which exports are free of VAT and imports are taxed on the same basis as domestic supplies) serves a crucial role in this context in facilitating the ultimate taxation of internationally traded services and intangibles according to the rules of the jurisdiction of consumption under Guideline 3.1. In the business-to-business context, the destination principle is generally implemented by allocating the taxing rights over internationally traded supplies to the jurisdiction where business use is deemed to occur, as this facilitates the ultimate goal of ensuring that tax is paid and revenue accrues to the jurisdiction where the supply to the final consumer occurs. This ensures that services and intangibles supplied across borders are taxed according to the rules of the customer's jurisdiction irrespective of where they are obtained, thus creating a level playing field. Businesses acquiring such services are therefore driven by economic, rather than tax, considerations.

3.5 Determining the place of business use in connection with a business-to-business supply is often difficult, particularly with regard to services and intangibles. To take an example, a person in Jurisdiction X may contact a company for the development of software in Jurisdiction A, download the newly developed software to a laptop computer in Jurisdiction B and use it, for example, at a business conference in Jurisdiction C. In these circumstances, a case could be made that business use takes place in whatever jurisdiction the software is accessed and used. However, this would be impossible to administer. In most cases it would be difficult for a business to track use of services or intangibles in this way and difficult for a tax administration to know where the services or intangibles were used. Even if the usage could be tracked, it would again, be difficult to place a monetary value on it in order to determine an amount of tax due and the compliance burdens on business and tax administrations would be unreasonable. In order to

[20] For the purpose of this section, "*internationally traded services and intangibles*" normally result from the supplier and the customer being located in different jurisdictions.

[21] At this stage, the draft Guidelines address only the implementation of the destination principle for cross-border supplies of services and intangibles between businesses ("B2B"). Future work will include the development of Guidelines on implementing the destination principle for cross-border supplies of services and intangibles to final consumers ("B2C").

[22] In practice, a business may acquire goods or services that are used in whole or in part for the private consumption of the business owners. Where this is the case, VAT regimes may have to determine whether, or the extent to which, the purchase should be treated as acquired for business purposes or for private consumption.

overcome these difficulties, VATs employ proxies to determine where business use occurs and thus which jurisdiction has the right to tax.

3.3 Business-to-business supplies

3.3.1 Main Rule

a) Defining the Main Rule

Guideline 3.2

For the application of Guideline 3.1, the OECD has adopted the following Guideline:

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

3.6 By and large, when a business buys in services or intangibles from another jurisdiction, it does so for the purposes of its business operations. As such, the jurisdiction of the customer's location can stand as the appropriate proxy for the jurisdiction of business use as it achieves the objective of neutrality by implementing the destination principle. This is the jurisdiction where the customer has located its permanent business presence.

3.7 This proxy is referred to in these Guidelines as the "*Main Rule*". According to the Main Rule, the jurisdiction where the customer is located has the taxing rights over services or intangibles supplied across international borders. At the same time, the supplier makes the supply free of VAT in its jurisdiction but retains the right to full input tax credit (subject to clearly legislated exceptions in that jurisdiction) on inputs related to making such international supplies. Only in specified or exceptional circumstances[23] should the place of taxation vary from the Main Rule. Determining the jurisdiction of a customer's location may not always be straightforward and this section sets out how such determinations should be made.

Guideline 3.3

For the application of Guideline 3.2, the OECD has adopted the following Guideline:

The identity of the customer is normally determined by reference to the business agreement.

3.8 Under Guideline 3.3, the identity of the customer is "*normally determined by reference to the business agreement*" as it is expected that business agreements reflect the underlying supply.[24] When supplies are made between separate legal entities with single locations only, the location of the customer will be known once the identity of the customer is determined. The business agreement is thus an important element of that Guideline in that it will assist the supplier, the customer and tax administrations in identifying the nature of the supply and the identity of the parties to the supply. For these reasons, it is appropriate to first describe "*business agreement*" for the purposes of these Guidelines and explain how tax administrations and businesses may approach this.

[23] As set out in Section 3.3.2 Specific Rules hereafter

[24] For the purposes of the Guidelines, a supply of services or intangibles for VAT purposes (hereafter a "*supply*") takes place where one party to a business agreement does something, gives something or refrains from doing something to or for another party, normally in exchange for consideration.

Box 3.1

Business Agreement

Business agreements consist of the elements that identify the parties to a supply and the rights and obligations with respect to that supply.[25] They are generally based on mutual understanding.[26]

3.9 The term "*business agreement*" has been adopted because it is a general concept, rather than a term with a technical meaning, and it is not specific to any individual jurisdiction. In particular, it is not restricted to a contract (whether written or in some other format) and is therefore wide in its application, as explained below.

3.10 In order to determine the place of taxation under the Main Rule, it is necessary to demonstrate the nature of the supply as well as the identity of the supplier and the customer.

3.11 Relevant elements of the business agreement come in many forms and include, for example, general correspondence, service level agreements, purchase orders, invoices, payment instruments and receipts. Legislation and business practices in OECD and other jurisdictions invariably differ and generally not for tax reasons. They may differ with respect to national laws concerning contract issues and other commercial requirements. They may also differ between different industry sectors. It is, therefore, neither possible nor desirable to draw up a prescriptive or exhaustive list of items that must be present in a business agreement. Rather, these Guidelines suggest sources of information that would help both tax administrations and business.

3.12 In many cases, particularly those involving significant sums of money or complex matters beyond a straightforward supply, it is likely that the parties to a business agreement will draw up legally enforceable contracts. These contracts will normally specify the parties to the business agreement and set out their respective rights and obligations. However, contracts in themselves should not be seen as the only relevant elements of a business agreement.

3.13 A business agreement need not be confined to written material. In certain sectors, relevant elements may be found in the form of audio recordings of telephone conversations leading to conclusions of agreements to supply or receive services and/or rights. Relevant elements of a business agreement may also be found in electronic form such as e-mails and on-line ordering records, payment and similar material and formats that are likely to emerge as new technologies develop.

3.14 It is recognised that business agreements are often not concluded in isolation. Consequently other agreements, including those not regarded as business agreements (e.g. agreements that do not involve a supply),[27] may provide the context of the supplies made under a particular business agreement. These other agreements may therefore form a part of the relevant elements of that business agreement.

3.15 In the light of the previous paragraphs, the business agreement in force at the time the supply is made is the agreement that governs the implementation of the Main Rule.

[25] Agreements that do not lead to supplies for tax purposes are not regarded on their own as "*business agreements*" for the purposes of these Guidelines.

[26] It is recognised, however, that on occasion supplies may occur without a mutual understanding, e.g. a court order that imposes obligations on one or more parties. In such cases the "*imposed*" agreement should nevertheless be considered as a "*business agreement*".

[27] An illustration of this is the Centralised Purchasing Agreement in Example 3 and the Framework Agreement in Examples 4 and 5 in Annex 1.

3.16 To ease burdens in practice for both tax administrations and business, it is recommended that jurisdictions take into account the application of Guidelines 3.2 and 3.3 in a way that is consistent with the previous paragraphs. Wherever possible, tax administrations should communicate these approaches and relevant national laws as clearly and as widely as possible.

Guideline 3.4

For the application of Guideline 3.2, the OECD has adopted the following Guideline:

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

3.17 When a supply is made to a legal entity that has establishments[28] in more than one jurisdiction (*a "multiple location entity", "MLE"*), an analysis is required to determine which of the jurisdictions where this MLE has establishments has taxing rights over the services or intangibles acquired by the MLE.

3.18 In such a case, the location where the customer establishment uses the service or intangible, in whole or in part, is the jurisdiction that has the taxing rights over the service or intangible. "*Use of a service or intangible*[29]" in this context refers to the use of a service or intangible by a business for the purpose of its business operations. It is irrelevant whether this use is immediate or continuous or is intended to take place in the future. It is also irrelevant whether this use is directly linked to an output transaction or supports the business operations in general.

Guideline 3.5

For the application of Guideline 3.4, the OECD has adopted the following Guideline:

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

3.19 A service or intangible supplied by an external supplier to a MLE may be acquired by one of its establishments for its other establishments located in different jurisdictions. The cost of acquiring such a service or intangible is then initially borne by the establishment that has entered into the business agreement with the external supplier and is subsequently recharged to the establishment(s) using the service or intangible. In line with normal business practice, these establishments of use[30] will be charged for this service or intangible on the basis of internal recharge arrangements, in accordance with corporate tax, accounting or other regulatory requirements.

[28] Registration for VAT purposes by itself does not constitute an establishment for the purposes of these Guidelines.

[29] "*Use of a service or intangible*" differs from the concept of "*use and enjoyment*" existing in national laws, which can refer to actual use by a customer in a jurisdiction irrespectively of the presence of any customer establishment.

[30] The term "*establishment of use*" will be used hereafter to refer to the establishment of the MLE that uses the service or intangible and is internally charged for this use.

3.20 According to Guideline 3.5 a two-step method is applied to allocate the taxing rights over such services or intangibles to the jurisdiction(s) where the customer establishment(s) using the service or intangible is (are) located. This two-step method is called the "*recharge method*":

- The first step follows the business agreement between the external supplier and the MLE. The taxing rights over the supply to the MLE are allocated to the jurisdiction of the customer establishment that enters into the business agreement with the supplier on behalf of the MLE.
- The second step follows the internal recharge within the customer MLE to the establishment(s) using the service or intangible. This internal recharge is used as a basis for allocating the taxing rights over the service or intangible to the jurisdiction where the establishment(s) of use is (are) located. This is achieved by treating these internal recharges as consideration for a supply within the scope of VAT.

3.21 This recharge according to internal recharge arrangements will be required when the services or intangible is purchased by one establishment for use by one or more other establishments. In situations where such recharge is not made, VAT will in principle[31] be applied as if a recharge arrangement were effectively in place so as to ensure that taxing rights accrue to the jurisdiction of use.

3.22 There is no recharge when the use is wholly by the establishment that entered into the business agreement on behalf of the MLE.

3.23 This Guideline does not deal with the VAT treatment of internally generated or developed services or intangibles, or with the value that is added internally (e.g. salary expense of wholly internally supplied services) to services or intangibles acquired from an external supplier.

Box 3.2

Recharge arrangement

The recharge arrangement is the arrangement that undertakes the role of the business agreement for internal recharges that are treated as supplies within the scope of VAT under the recharge method. The recharge arrangement consists of elements that identify the parts of the MLE that make and receive an internal supply that is within the scope of VAT and the internal rights and obligations with respect to this supply.

3.24 It is reasonable to expect that MLEs will have internal arrangements in place to support and facilitate the internal charges between their different establishments. These internal arrangements are referred to as "*recharge arrangements*" for the purpose of the application of the recharge method.

3.25 The term recharge arrangement has been adopted as a general concept, rather than a term with a technical meaning and it is not specific to any particular jurisdiction. It may also differ between different industry sectors. It is, therefore, neither possible nor desirable to draw up a prescriptive or exhaustive list of items that must be present in a recharge arrangement. Rather, these Guidelines suggest sources of information and relevant elements that would help both tax administrations and business to specify the parties to a recharge arrangement and their respective rights and obligations.

[31] The cases in which there would be use by one or more establishments other than the establishment that has entered into the business agreement without a recharge arrangement should remain limited. However, when this occurs, tax administrations and the MLE's establishment(s) concerned are encouraged to review the issue with a view to addressing any risks of double taxation or unintended non-taxation.

3.26 In this context the various elements of the recharge arrangements should identify the establishment of recharge[32] and the establishment(s) of use to which an internal recharge is made and provide sufficient information to evidence a consistent and correct VAT treatment of the recharge. Further, those elements should establish the link between the price of the initial supply and the amount of the recharge without requiring a recharge on a transaction-by-transaction basis.

3.27 In line with normal audit policies, tax administrations will need an audit trail that enables them, when necessary, to review the various elements of the recharge arrangement down to the transaction level, in order to identify the nature of the individual service that is recharged and so determine its place of taxation and the applicable rate.

3.28 The recharge arrangement is not confined to written material. For example electronic records and documents, general internal correspondence, documents equivalent to invoices, payments, cash flow or accounting entries made in the accounting system or similar material and forms may be considered as further evidence clarifying the existence and content of the recharge arrangement.

3.29 Other agreements at company level, may provide the context of the recharges made under a particular recharge arrangement. These other agreements may therefore form a part of the relevant elements of that recharge arrangement.

3.30 The application of the recharge method in practice is set out in more detail in paragraphs 3.51 et seq.

b) Applying the Main Rule – Legal entities[33] *with single locations ("single location entities" – "SLEs")*

3.31 In the following sub-sections, the businesses to which the Main Rule applies are assumed to be separate legal entities, whether related by common ownership or not.

3.32 For the purposes of this section it is assumed that the supplier and customer (legal entities with single locations) are located solely in their respective jurisdictions and have no business presence elsewhere.

3.33 As noted in paragraph 3.6 above, the place of the customer's location serves as a proxy for the jurisdiction of business use under the destination principle as implemented with respect to business-to-business supplies. As noted in paragraph 3.7 above, this proxy is referred to in these Guidelines as the Main Rule. The result of applying the Main Rule is that the jurisdiction where the customer is located has the taxing rights over a service or intangible supplied across international borders.

3.34 In order to apply the Main Rule satisfactorily, this guidance considers its application from the perspectives of the supplier, customer and tax administrations. Although the result remains the same – taxation at the place of the customer – the actions of all three need to be consistent with the Guideline. Examples 1 and 2 in Annex 1 provide relatively straightforward illustrations of how the Main Rule operates. Examples 3, 4 and 5 in Annex 1 illustrate how the Main Rule is applied in more complex situations.

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[32] The term "*establishment of recharge*" will be used hereafter to refer to the establishment of the MLE that enters into the business agreement with an external supplier and which subsequently makes the internal recharge.

[33] Legal entities can include natural persons and non-commercial institutions such as governments, non-profit organisations and other institutions. The key point is that such entities, or certain of their activities, are recognised as "*businesses*" for VAT purposes in national law.

The supplier[34]

3.35 In a business-to-business environment, it is reasonable to assume that suppliers will normally have developed a relationship with their customers. This will be particularly so in cases where supplies of services or intangibles are made on an on-going basis or in cases where one supply is made and the value of that supply is significant enough to warrant development of business agreements such as contracts. However, it is recognised that situations can arise where there is little, if any, relationship between the supplier and the customer. For example, businesses may make supplies to other businesses with which they have no relationship for low value amounts, particularly if such supplies are made electronically.

3.36 The principal effect of the Main Rule on suppliers is that they need to identify and be able to demonstrate who their customer is in order to make the supply free of VAT because the customer is located outside the supplier's jurisdiction. Once satisfied that the customer is a business and is located in another jurisdiction, the supplier makes that supply free of VAT as, under the Main Rule, the taxing rights over that supply are in the jurisdiction of the customer's location.

3.37 In many cases this will be straightforward and can be determined by reference to the business agreement including the elements considered in paragraph 3.11 et seq. The nature of the service or intangible being supplied and the language used in any supporting documentation may also contribute to verification of the international and business nature of the supply.

3.38 To avoid unnecessary burdens on suppliers, it is recommended that the customer be liable to account for any tax due. This can be achieved through the reverse-charge mechanism (sometimes referred to as "*tax shift*" or "*self-assessment*") where that is consistent with the overall design of the national consumption tax system.[35] Accordingly, the supplier should not be required to be identified for VAT or account for tax in the customer's jurisdiction.

3.39 There will be occasions when the supplier and customer are related through some form of common ownership, management or control. As noted above, provided the supplier and customer are separate legal entities the Main Rule applies and does not affect the approaches set out above, as long as the supplies are bona fide and not arranged in such a way that avoids or artificially minimises VAT.

3.40. As suggested by the foregoing paragraphs, application of the Main Rule will not be influenced by the circumstance that the supplier (i) supplies a customer who supplies onwards the services or intangibles to a third party,[36] (ii) directly provides[37] the services or intangibles to a third party that is not the customer under the business agreement or (iii) is paid by a third party that is not the customer under the business agreement:

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[34] For the purpose of these Guidelines, the supplier is the person that has the obligation to provide a supply.

[35] For the purposes of these Guidelines, the "*reverse-charge mechanism*" is a tax mechanism that switches the liability to pay the tax from the supplier to the customer. If the customer's establishment is entitled to full input tax credit in respect of this supply, it may be that local VAT legislation does not require the reverse-charge to be made. In such cases tax administrations are encouraged to publicise this.

[36] For the purposes of these Guidelines, a third party is an entity recognised as a "*business*". "*Third party*" refers to a party other than the supplier or the customer and has no necessary correlation to its meaning in other contexts, including direct taxation.

[37] For example, a person (C) may order flowers to be sent to another person (R). C enters into a business agreement with the florist (F) and F directly provides the flowers to R. But the supply is made between F and C. (It is recognised that this situation concerns what is typically a business-to-consumer supply of goods but is included here to emphasise the point in a way that is easily recognised and understood.)

(i) The customer supplies onwards the services or intangibles to a third party business located in the jurisdiction of the supplier

It is common for multinational businesses to centralise certain procurement activities in one jurisdiction in order to obtain the economic benefits of single large agreements as opposed to multiple lower value agreements. These are generally referred to as "*global*" agreements. The central procurement company then supplies onwards the supplies or parts of the supplies to the various associated businesses around the world.

The onward supply of those services to associated businesses will be covered by separate business agreements entered into between the central procurement company and each of the associated businesses. If the associated businesses are the customers under those business agreements, they will account for any VAT due under the Main Rule using the reverse-charge mechanism at the rate applicable in their jurisdictions.

The procurement company may well supply a business located in the same jurisdiction as the original supplier (see Annex 1– Example 3). When applying the Main Rule, the place of taxation should be decided for each supply individually so that the determination of the place of taxation of services or intangibles for VAT purposes will not be influenced by any subsequent supply or lack of such supply. The supplier should accordingly determine the identity of the customer by reference to the relevant business agreement. Where the customer is located in another jurisdiction, the supplier is entitled to make the supply free of VAT. The fact that the customer subsequently supplies the services or intangibles onwards is not, in itself, relevant, even where the third party is located in the jurisdiction of the supplier.

(ii) The supplier directly provides the services or intangibles to a third party business different from the customer

Further to the circumstances explained at (i), the supplier may also be required under the terms of the business agreement to directly provide services or intangibles to a third party (see Annex 1 – Example 3). As long as this is done as part of a bona fide supply, the customer remains the customer identified in the business agreement and it is this customer's location that determines the place of taxation. The mere direct provision of the supply to a third party does not, in itself, affect that outcome. Accordingly, the Main Rule should be applied in such a way that the supplier makes a supply free of VAT to an overseas customer even if the third party is located in the same jurisdiction as the supplier.

(iii) The supplier is paid by a third party business that is not the customer under the business agreement

Particular care may be required where payment flows differ from the flows of services or intangibles. Typically, a customer pays a supplier for services or intangibles supplied under a business agreement. However, there may be other circumstances where another party may pay for that supply. For instance, it is common for multinational groups of businesses to reduce costs by appointing a company within a group to be the "*paymaster*"[38] responsible for payments under the relevant agreement to pay for services received. In such cases, services or intangibles supplied by the supplier or the supplier's overseas subsidiaries to overseas customers may be paid for by the customer's parent business located in the supplier's jurisdiction. Supplies may not be made to the parent business (See Annex 1 – Example 5). When applying the Main Rule, the place of taxation should be decided for each

[38] This company may be referred to as a "*paymaster*", "*cash clearing agent*", "*billing agent*" or some other such term. This guidance uses the term "*paymaster*"

supply individually. The direction of the payment flows and the identity and location of the payer are not, in themselves, relevant. The payment flows are consideration for the supplies under the relevant business agreements but do not, in themselves, create additional supplies, alter the supplies, nor identify the customer or customer location. Accordingly, the supplier makes the supply to the customer identified in the relevant business agreement and the place of taxation is that customer's location. The supplier is therefore entitled to make a supply free of VAT to an overseas customer even if that supply is paid by a third party located in the same jurisdiction as the supplier.

The customer[39]

3.41 As stated in paragraph 3.38, the customer should be liable to account for any tax due under the reverse-charge mechanism where that is consistent with the overall design of the national consumption tax system. Under this procedure, the customer is typically required to declare the VAT due on the supply received from the overseas supplier as output tax on the relevant VAT return. The rate to be applied is the rate applicable in the customer's jurisdiction. The customer is then entitled to input tax deduction to the extent allowed under the rules of its jurisdiction.

3.42 If the customer is entitled to full input tax deduction on the relevant supply, it may be that local VAT legislation does not require declaration of the output tax under the reverse-charge mechanism. This is an option provided in some jurisdictions and businesses in this position should ensure that they are aware of their jurisdiction's requirements in this respect. Similarly, some jurisdictions may employ a type of VAT that does not require application of a reverse-charge as it would not suit the nature of the tax as applied. Businesses importing services and intangibles from an overseas supplier should ensure that they are familiar with their domestic legislation and administrative practices.

3.43 The customer is obliged to pay any tax due on the supply under the reverse-charge mechanism where that is consistent with the overall design of the national consumption tax system. The customer should be liable to pay even where (i) the customer supplies onwards the services or intangibles to a third party (ii) the services or intangibles are not directly provided to the customer or (iii) the customer does not pay for the supply:

(i) The customer supplies onwards the services or intangibles to a third party business

As stated in paragraph 3.40(i), it may be that the customer supplies onwards the services or intangibles from the foreign supplier as separate supplies (e.g. within a "*global*" agreement). Provided such onward supplies are bona fide and are not made as part of any arrangements designed to artificially minimise or eliminate VAT, the place of taxation should be decided for each supply individually and the original international supply is not affected (see Annex 1 – Example 3). The Main Rule continues to apply. It is likely that the customer when supplying onwards the supplies or parts of the supplies to associated businesses will have entered into business agreements with those businesses. Each of those associated businesses that is identified as the customer of the original customer under the business agreements will have to account for any VAT due under the reverse-charge mechanism at the rate applicable in its jurisdiction.

[39] For the purposes of this guidance, the customer is the person that has the right to the supply from the supplier, notwithstanding whether the supply is actually directly provided to that customer or another party or the payment is made by that customer or another party.

(ii) The services or intangibles are not directly provided to the customer

As described in paragraph 3.40(ii) above, the customer may, under the terms of the relevant business agreement, require that the services or intangibles be directly provided to a third party. Even if that third party is located in a different jurisdiction from that of the customer identified in the business agreement, the customer retains the liability to account for any tax on that supply (see Annex 1 – Example 3).

(iii) The customer does not pay for the supply

As described in paragraph 3.40(iii) above, multinational business groups may appoint a group member to act as paymaster for services or intangibles supplied to the group (i.e. a "*paymaster*" agreement). Consequently, the customer is not the party who pays for the supply under the business agreement. In such situations the direction of the payment flows and the identity and location of the payer are not, in themselves, relevant. The supply is to the customer identified in the relevant business agreement and the place of taxation is that customer's location (see Annex 1 – Example 5).

Tax administrations

3.44 The growth in international supplies of services and intangibles has led to increased complexity for tax administrations as well as businesses. The intangible nature of many services is such that the comparative simplicity for goods (exports relieved, imports taxed) cannot be replicated with respect to services and intangibles. It is, therefore, important that tax administrations make it clear to both businesses and to staff responsible for carrying out compliance checks and audits what the rules are in their own jurisdiction and that they should be applied according to the facts of each individual supply.

3.45 Under the Main Rule supplies of services and intangibles are subject to tax according to the rules of the jurisdiction where the customer is located. This means that a supplier of international business-to-business services and intangibles makes such supplies free of VAT. As stated in paragraph 3.36, the tax administration of the supplier may therefore require the supplier to produce evidence that the customer is a business and that this business is located in another jurisdiction. To minimise compliance burdens on the supplier, tax administrations are encouraged to provide businesses with clear guidance on the evidence they require.

3.46 Equally, as stated in paragraphs 3.38 and 3.43, the customer accounts for any VAT due to its local tax administration under the reverse-charge mechanism where that is consistent with the overall design of the national consumption tax system. Tax administrations are encouraged to make businesses aware of the need to account for any tax on "*imported*" services and intangibles from their suppliers in other jurisdictions. The normal domestic rate applicable to the nature of the services or intangibles involved should be applied. If the customer is entitled to full input tax credit in respect of this supply, it may be that local VAT legislation does not require the reverse-charge to be declared on the local VAT return. In such cases tax administrations are encouraged to publicise this to business. Jurisdictions that require this declaration should likewise make it clear that tax is required to be accounted for in this way.[40]

3.47 The reverse-charge mechanism has a number of key advantages. First, the tax authority in the jurisdiction of business use can verify and ensure compliance since that authority has personal jurisdiction

[40] In cases where a customer omits to account properly for such reverse-charge, but is still, nevertheless, entitled to full input tax deduction in respect of that supply, it is recommended that any penalties that might be applied should be proportionate and linked to the gravity of the failure made, where the gravity of the failure is a consideration, bearing in mind there is no net revenue loss.

over the customer. Second, the compliance burden is largely shifted from the supplier to the customer and is minimised since the customer has full access to the details of the supply. Third, the administrative costs for the tax authority are also low because the supplier is not required to comply with tax obligations in the customer's jurisdiction (e.g. VAT identification, audits, which would otherwise have to be administered, and translation and language barriers). Finally, it reduces the revenue risks associated with the collection of tax by non-resident suppliers, whether or not that supplier's customers are entitled to deduct the input tax.

3.48 The determination of the place of taxation of services or intangibles for VAT purposes should be decided for each supply individually. It will, therefore, not be influenced by (i) any subsequent onward supply or lack of such supply, (ii) the mere direct provision of the services or intangibles to a third party business other than the customer or (iii) by the direction of the payment flows and the identity and location of the payer:

(i) The determination of place of taxation should not be influenced by any onward supply:

As stated in paragraphs 3.40(i) and 3.43(i), businesses with associated separate legal entities in other jurisdictions may supply onwards the services or intangibles they have bought in within a "*global*" agreement from overseas to other related companies. These supplies should be subject to the normal VAT rules, including the Main Rule in respect of international services and intangibles (see Annex 1 – Example 3). Accordingly, it is recommended that:

- the tax administration in the supplier's jurisdiction allow the supplier to make a supply free of VAT, providing the supplier can identify the customer and demonstrate that the customer is located overseas;
- the tax administration in the customer's jurisdiction ensure that the customer accounts for any tax due on the supply from the overseas supplier, using the reverse-charge mechanism.

(ii) The determination of the place of taxation should not be influenced by the direct provision of the services or intangibles to a third party business other than the customer:

As stated in paragraph 3.40(ii) and 3.43(ii), even if some or all of the services or intangibles are not directly provided in the jurisdiction of the customer but rather are directly provided in another jurisdiction such as, for instance, the jurisdiction of the supplier or in a third party's jurisdiction, the Main Rule continues to apply (see Annex 1 – Example 3). The customer's jurisdiction remains the jurisdiction with the taxing rights as long as such on-supplies are bona fide and are not made as part of any arrangements designed to artificially minimise or eliminate VAT. For example, an accountancy firm may have entered into a business agreement with a customer located in another jurisdiction but may perform much of the work in its own jurisdiction and also provide its services directly to a third party. This does not, in itself, prevent the place of taxation from being the customer's location. Accordingly it is recommended that:

- the tax administration in the supplier's jurisdiction does not seek tax from the supplier where that supplier is merely directly providing the services or intangibles there, but allows it to make a supply free of VAT to the overseas customer identified in the business agreement;
- the tax administration in the customer's jurisdiction ensures that the customer accounts for any tax due on the supply from the overseas supplier, using the reverse-charge mechanism, even if the services or intangibles were directly provided by a local third party.

(iii) *The determination of the place of taxation should not be influenced by the direction of the payment flows and the identity and location of the payer:*

Paragraph 3.40(iii) and 3.43(iii) above recognise that there may be situations where another party pays for the supply to the customer in the business agreement (see Annex 1 – Example 5). That third party is usually referred to in multinational groups as the group "*paymaster*" and may not be supplied with any services or intangibles itself. Irrespective of where that third party is located, the services or intangibles are supplied to the customer identified in the relevant business agreement and the taxing rights belong to the jurisdiction in which that customer is located. Accordingly it is recommended that:

- the tax administration in the supplier's jurisdiction does not seek tax from the supplier merely because the paymaster third party is located there, but allows it to make the supply free of VAT to the overseas customer identified in the business agreement;
- the tax administration in the customer's jurisdiction ensures that the customer accounts for any tax due on the supply from the overseas supplier, using the reverse-charge mechanism, even if the supply is paid for by a third party.

3.49 The above approach ensures a logical result because supplies are subject to tax in the jurisdiction in which the services or intangibles are used by the business in accordance with the destination principle as implemented by the Main Rule and there is neither double taxation nor unintentional non-taxation in any of the jurisdictions involved. Where this is not the case, tax administrations will need to ensure that supplies are not arranged in such a way as to artificially minimise or eliminate VAT liability for any of the parties concerned. Guidelines on dealing with tax avoidance and abuses will be developed as part of further work.

3.50 Annex 1 provides some examples of how the Guidelines on place of taxation for supplies of services and intangibles to Single Legal Entities can be applied in practice.

c) Applying the Main Rule – Legal entities with multiple locations (multiple location entities - "MLEs")

3.51 In those cases where the service or intangible is used by one or more establishments of a MLE other than the establishment that entered into the business agreement, the taxing rights are allocated according to a two-step method which is called the "*recharge method*". The first step follows the business agreement between the external supplier and the MLE. The second step follows the internal recharge within the customer MLE to the establishment(s) using the service or intangible.

3.52 The following sub-sections consider the application of the recharge method from the perspectives of the supplier, customer and tax administrations.

First step: supply to the MLE

Supplier

3.53 As is the case for any supply, the supplier will need to identify and be able to demonstrate who the customer is and where this customer is located in order to determine where the taxing rights will accrue.

3.54 When the customer is a MLE, the taxing rights will be allocated to the jurisdiction of the establishment that represents the MLE in the business agreement with the supplier. The various elements of the business agreement with the supplier should identify this establishment and where it is located. Once satisfied that this establishment is located in another jurisdiction, the supplier will be entitled to make the supply free of VAT.

Customer

3.55 Where the customer establishment that has represented the MLE in the business agreement is located in a jurisdiction other than the supplier, it is recommended that this establishment be liable for any tax due on the transaction. This can be achieved through reverse charge mechanisms (also referred to as "*tax shift*" or "*self assessment*") where this is consistent with the overall design of the national consumption tax system. Under this procedure, the customer establishment will typically be required to declare the tax due on the supply received from the foreign supplier as output tax on the relevant VAT return. The rate to be applied is the normal domestic rate applicable to the nature of the service or intangible in the jurisdiction of the customer establishment. The customer establishment that makes the recharge will deduct the related input tax in line with the normal rules that ensure VAT neutrality.

3.56 If the customer establishment that has represented the MLE in the business agreement is entitled to full input tax credit in respect of this supply, it may be that local VAT legislation does not require the reverse-charge to be made.

Tax administrations

3.57 The tax administration in the jurisdiction of the supplier will need to know the nature of the supply as well as the identity of the customer and the jurisdiction in which the customer is located. Where services or intangibles are supplied to a business located in another jurisdiction, these supplies will be made free of VAT. The supplier will therefore need to hold all the relevant information that constitutes the business agreement to demonstrate the nature of the supply and the identity of the customer. Where this customer is a MLE, the business agreement will need to provide evidence of the identity of the establishment that enters into the business agreement on behalf of the MLE and the location of this establishment. Tax administrations are encouraged to provide businesses with clear guidance on the evidence they require.

3.58 The customer's establishment that has entered into the business agreement with the supplier accounts for any VAT due to its local tax administration under the reverse-charge mechanism where that is consistent with the overall design of the national consumption tax system. Tax administrations are encouraged to make businesses aware of the need to account for any tax on "imported" services or intangibles from suppliers in other jurisdictions, including if these services or intangibles are acquired by an establishment of a MLE.

3.59 If the customer's establishment is entitled to full input tax credit in respect of this supply, it may be that local VAT legislation does not require the reverse-charge to be made. In such cases tax administrations are encouraged to publicise this.

Second step: recharge to the establishment(s) of use

Supplier

3.60 The external supplier of the service or intangible to the MLE has no involvement in the recharge of the service or intangible to the customer's establishment of use. This is the sole responsibility of the customer MLE.

Customer

3.61 The customer's establishment that has entered into the business agreement with the external supplier will either have acquired the service or intangible for its own use or will have acquired it for use by other establishments of the customer MLE. In the latter case, the customer establishment that has entered into the business agreement with the external supplier is required to subsequently charge the other establishment(s) of the MLE using the service or intangible. Under the recharge method, this internal charge is treated as consideration for a supply within the scope of VAT.

3.62 There will be no recharge if the service or intangible was acquired by an establishment of the MLE for its own use.

3.63 Whether or not there will be a recharge for a service or intangible acquired by an establishment of a MLE for use by another establishment of this MLE in the same jurisdiction, will depend on the internal rules of this jurisdiction. This Guideline only deals with cross-border supplies of services and intangibles.

3.64 As for any other supply, the establishment of recharge will need to identify and be able to demonstrate which is the establishment of use and where this establishment is located.

3.65 MLEs will need to have internal arrangements in place to support and facilitate the internal charges between their different establishments. MLEs and tax administrations will rely on these internal arrangements to provide them with the information that would otherwise be covered by a business agreement. These internal arrangements are referred to as "*recharge arrangements*" for the purpose of the application of the recharge method.

3.66 The various elements of the recharge arrangement should identify the establishment of recharge and the establishment(s) of use to which an internal recharge is made and should provide sufficient information to evidence a consistent and correct VAT treatment of the recharge.

3.67 This may be straightforward in many cases, particularly where MLEs have adopted an arrangement where specific services or intangibles acquired externally are recharged as such to the establishment of use. This may for instance be the case for large expenses that can be isolated and charged to the establishment of use, for example in installing a new computer system or performing a major upgrade. Such arrangements are of great practical convenience, as they allow the service or intangible that is recharged as well as the basis for the recharge to be clearly identified. MLEs are encouraged to adopt such arrangements as much as possible for their internal recharges.

3.68 It is accepted however that it will not always be possible to adopt this approach in practice. This may for instance be the case where a service or intangible is acquired for use by multiple establishments and a separate recording of use by each of the establishments would be disproportionately burdensome. This may for instance occur where legal services or marketing services are acquired centrally for several establishments of a MLE. A detailed analysis of these services and their use by each of the establishments may be difficult or overly burdensome in certain circumstances. In such cases, MLEs may find it necessary to use cost allocation or apportionment methods that include a certain degree of estimation or approximation of the actual use of the service by each establishment.

3.69 Tax administrations are encouraged to allow such cost allocation or apportionment methods where the straightforward recharge for specific services or intangibles would be disproportionately burdensome and to provide businesses with clear guidance on the allocation or apportionment approaches that they consider allowable.

3.70 Such cost allocation or apportionment methods (allocation keys) should be "*fair and reasonable*", in that they should produce recharges that are commensurate with the reasonably expected use by the establishments of use, follow sound accounting principles and contain safeguards against manipulation. Where possible, information that is already available for accounting and tax and other regulatory purposes should be used. There is no single solution that would be appropriate in all cases. What is "*fair and reasonable*" not only depends on the type of service but also on the size and structure of a company, the sector and the complexity of the business environment it operates in. Whatever allocation key is used, it must be capable of being justified and applied consistently without creating undue compliance and administrative burden for businesses and tax administrations.

3.71 Commonly used allocation keys include: number of employees, square meters of office space, number of fleet cars, computer usage, advertising expenses, number of accounting entries, number of invoices processed, etc. A clear, directly measurable allocation key may not always be available, for example in relation to legal expenses, general systems maintenance etc. In such cases, it is not uncommon for costs to be allocated on the basis of the respective size of the establishments.

3.72 It is important that the relationship between the initial supply of the service or intangible to the MLE (first step) and the onward recharge to the establishment(s) of use (second step) does not become obscured. The objective of the recharge method is to ensure that taxing rights over supplies to an MLE are effectively allocated to the jurisdiction where the establishment of use is located. The MLE is therefore expected to ensure that tax administrations can reasonably establish the relationship between the initial supply and the recharge and that they can notably establish the link between the price of the initial supply and the amount of the recharge without requiring a recharge on a transaction-by-transaction basis.

3.73 The establishment of recharge will be entitled to make the recharge free of VAT on the basis of the information available in the recharge arrangement as the other establishment(s) is (are) located in other jurisdictions. The elements of the recharge arrangement should demonstrate which establishment(s) is (are) using the service and its (their) location in another jurisdiction. It is recommended that the establishment of recharge would issue a document equivalent to an invoice for the recharge to the establishment(s) of use.

3.74 To ensure VAT neutrality for the establishment that makes the recharge, general input VAT deduction rules should apply for this establishment in respect of the input VAT on the service or intangible received and subsequently recharged. The application of the recharge method should not influence the MLE's right to input VAT deduction in respect of purchases other than the service or intangible to which the Recharge Method is applied.

3.75 It is recommended that the establishment of use be liable for any tax due on the recharge. This can be achieved through reverse charge mechanisms (also referred to as "*tax shift*" or "*self assessment*") where this is consistent with the overall design of the national consumption tax system. It may be that local VAT legislation does not require the reverse-charge to be made.

3.76 When a service or intangible is used wholly by an establishment other than the one that entered into the business agreement, the taxable amount will in principle be the amount of the recharge that corresponds to the purchase price of the service or intangible.

3.77 Where the service or intangible is used by several establishments, the taxable amount for each establishment will be the part of the purchase price of the service or intangible that is recharged to this establishment on the basis of an acceptable apportionment or allocation approach.

3.78 The taxable amount should be evidenced by the recharge arrangement. The rate to be applied is the normal domestic rate applicable to the nature of the service or intangible in the jurisdiction of the customer establishment of use. This customer establishment is then entitled to deduct input tax to the extent allowed under the rules of its jurisdiction.

3.79 Where the recharge of a service or intangible purchased from an external supplier is bundled with a wholly internal cost charge (e.g. salary expense of wholly internally supplied services), it is for the MLE to separate the cost of the externally purchased service or intangible from the other costs and to evidence the internal character of these other costs if this is necessary to ensure that the recharge method is only applied on the cost of the externally purchased service or intangible.

3.80 It is recommended that normal time of taxation rules be applied to the internal recharge. These are generally based on the moment where the service is completed, or when a payment is made or document (i.e. equivalent to an invoice for the internal recharge) is issued. Tax administrations may wish to consider an approach where MLEs are required to make recharges within a reasonable delay following the time of taxation of the supply for which the recharge is made. In addition, tax administrations may wish to consider that the point of taxation for the recharge arises no later than at the moment when the service is completed or, in case of continuous supplies, at the end of each tax period.

Tax administrations

3.81 In line with normal audit policies, tax administrations will need an audit trail that enables them, when necessary, to review commercial documentation down to the transaction level in order to identify the nature of the individual service that is recharged and so determine that the place of taxation, taxable amount and the applicable rate of tax are correct.

3.82 This documentation may include a copy of the original invoice from the external supplier, the allocation method and allocation key used, and any other documents or electronic records that show how the VAT was calculated (e.g. distinction between recharge of external costs and internal added value), the documentation from the establishment that makes the recharge requesting payment (i.e. document equivalent to an invoice), accounting entries and payment by the establishment.

3.83 In addition, it will also be necessary for auditors at the tax administration in the jurisdiction of use to satisfy themselves that

- any cross-border payments between establishments where VAT has not been applied do not include recharges of external costs that are treated as consideration for a supply within the scope of VAT;

- establishments have accounted for VAT correctly on any such recharge within netting off payments. In such a case, VAT should not just be applied on this net value but should be applied on the taxable amount of each of the recharges;

- the establishment of use has accounted for VAT as if a recharge arrangement were in place, in cases where a service has been purchased by another establishment in a different jurisdiction and the establishment of use has not been recharged even though this recharge was required.

3.84 Where possible, tax administrations should use information that is already available for accounting or tax and other regulatory purposes, to avoid creation of new methodologies and processes purely for VAT purposes.

3.85 It is recommended that any tax due on the internal recharge would be accounted for by the MLE's establishment of use. This can be achieved through reverse charge mechanisms where this is consistent with the overall design of the national consumption tax system. However, it is recognised that local VAT legislation may not require the reverse-charge to be made if the establishment of use is entitled to full input tax credit in respect of this supply. In such cases, the tax administration is encouraged to publicise this. Jurisdictions that do require a reverse charge to be made are likewise recommended to make this clear.

3.86 Annex 2 provides an example of how the Guidelines on place of taxation for supplies of services and intangibles to a multiple location entity can be applied in practice.

3.3.2 Specific Rules

a) Evaluation framework for assessing the desirability of a specific rule

Guideline 3.6

The taxing rights over internationally traded services or intangibles supplied between businesses may be allocated by reference to a proxy other than customer location as laid down in Guideline 3.2, when both the following conditions are met:

a. The allocation of taxing rights by reference to customer location does not lead to an appropriate result when considered under the following criteria:

- **Neutrality**
- **Efficiency of compliance and administration**
- **Certainty and simplicity**
- **Effectiveness**
- **Fairness.**

b. A proxy other than customer location would lead to a significantly better result when considered under the same criteria.

3.87 According to Guideline 3.2, the jurisdiction where the customer is located has the taxing rights over services or intangibles supplied across international borders in a business-to-business context. This proxy is referred to in these Guidelines as the Main Rule. However, it is recognised that the Main Rule may not give an appropriate tax result in every situation and, where this is the case, the allocation of taxing rights by reference to a proxy other than customer location might be justified. A rule that allocates taxing rights using a proxy other than customer location is referred to in these Guidelines as a "*specific rule*". Such a rule will use a different proxy (e.g. supplier's location, place of performance, location of immovable property) to determine which jurisdiction has the taxing rights over a supply of service or intangible that is covered by the rule. Any such specific rule should be supported by clear criteria and should be limited to the greatest extent possible. Guideline 3.6 describes these criteria and sets out how they may justify the implementation of a specific rule.

3.88 Under Guideline 3.6, a two-step approach is recommended to determine whether a specific rule may be justified:

- The first step is to test whether the Main Rule leads to an appropriate result under the criteria set out under Guideline 3.6. Where this is the case, there is no need for a specific rule. Where analysis suggests that the Main Rule would not lead to an appropriate result, the use of a specific rule might be justified. In such case, a second step is required.

- In a second step, the proposed specific rule must also be tested against the criteria of Guideline 3.6. The use of a specific rule will be justified only when this analysis suggests that it would lead to a significantly better result than the use of the Main Rule.

3.89 These Guidelines do not aim to set out exactly for which supplies of services or intangibles a specific rule might be justified. Rather, they provide an evaluation framework for governments to assess the desirability of a specific rule against the background of a constantly changing technical and commercial environment. The next paragraphs describe this framework in further detail.

3.90 The evaluation framework for assessing the desirability of a specific rule builds on the overall objective of the Guidelines on place of taxation, as described in paragraph 3.2. In accordance with this objective, the evaluation framework for assessing the desirability of a specific rule on place of taxation consists of the following criteria:

- *Neutrality:* The six Guidelines on Neutrality and their comments (Guidelines 2.1 to 2.6).

- *Efficiency of compliance and administration:* Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

- *Certainty and simplicity:* The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

- *Effectiveness:* Tax rules should produce the right amount of tax at the right time and the right place.

- *Fairness:* The potential for tax evasion and avoidance should be minimised while keeping counter-acting measures proportionate to the risks involved.

3.91 Ensuring that the tax treatment of international supplies is in accordance with these criteria requires a consistent definition and implementation of place of taxation rules. The Main Rule on place of taxation, as set out in Guideline 3.2, is the recommended approach for ensuring a consistent determination of place of taxation for internationally traded services and intangibles. The use of specific rules that use different proxies from the Main Rule should be limited to the greatest possible extent, since the existence of specific rules will increase the risk of differences in interpretation and application between jurisdictions and thereby increase the risks of double taxation and unintended non-taxation.

3.92 When assessing the desirability of a specific rule on the basis of the evaluation framework set out above, it is important to consider each of the criteria while also recognising that they form a package. No single criterion can be considered in isolation as the criteria are all interconnected. For example, neutrality, as described in the Guidelines on neutrality and efficiency of compliance and administration are complementary to one another. Similarly, efficiency depends on the degree of certainty and simplicity, whereas certainty and simplicity are also fundamental to achieving effectiveness and fairness. It is therefore unlikely that evaluating the performance of the Main Rule (or an alternative specific rule) in a particular scenario would result in a very low ranking when judged against one or two criteria but a much higher ranking when judged against the other criteria. Rather, it is expected that the evaluation will show either a good or a poor outcome overall.

3.93 Consequently, it is recommended that governments consider implementing a specific rule for the allocation of taxing rights on internationally traded services and intangibles only if the overall outcome of the evaluation on the basis of the criteria set out in Guideline 3.6 suggests that the Main Rule would not lead to an appropriate result and an evaluation on the basis of the same criteria suggests that the proposed specific rule would lead to a significantly better result.

3.94 While there remains a level of subjectivity as to what is and what is not an "*appropriate result*" and what is "*a significantly better result*", Guideline 3.6 provides a framework for assessing the desirability of a specific rule that should make the adoption of such a rule more transparent, systematic, and verifiable. It is neither feasible nor desirable to provide more prescriptive instructions on what should be the outcome of the evaluation for all supplies of services and intangibles. However, the paragraphs below provide further guidance and specific considerations for particular supplies of services and intangibles for which a specific rule might be appropriate in some circumstances and conditions. The evaluation should be considered from the perspective of both businesses and the tax authorities.

b) Circumstances where a specific rule may be desirable

3.95 While it is recognised that the Main Rule meets the above-mentioned criteria in most circumstances, the business environment and the circumstances in which certain services or intangibles are supplied may help in predicting when the Main Rule is likely to fail the criteria and a specific rule may lead to a significantly better result. For example, this is likely to occur in a situation where all the following circumstances arise:

- particular services or intangibles are typically supplied to both businesses and final consumers,

- the service requires the physical presence of both the supplier and the customer in some way and,

- the service is used at a readily identifiable location.

3.96 If businesses that usually supply to a large number of customers for relatively small amounts in a short period of time (e.g. restaurant services) were required to follow the Main Rule, it would impose significant compliance burden on suppliers. Any person, businesses or final consumer, could simply state that he or she was a business located in another country and request that no VAT be charged. It would put the supplier at considerable risk of having to bear the under-declared tax if it was subsequently shown that the customer was not a business located in another country (breach of certainty and simplicity). This would also make tax administration controls more difficult as evidence of location may be difficult to produce (breach of efficiency).

3.97 The same could apply for services that consist of granting the right to access events such as a concert, a sport game, or even a trade fair or exhibition that is basically designed for businesses. If a ticket can be purchased at the entrance of the building where the event takes place, businesses as well as final consumers can be recipients of the service. In these cases, under the Main Rule the supplier is confronted with the difficulty and risk of identifying and evidencing the customer's status and location. Efficiency, as well as certainty and simplicity, may then not be met. Fairness could be at risk. The adoption of a specific rule allocating the taxing rights to the jurisdiction where the event takes place could meet the criteria and lead to a significantly better result.

c) *Special considerations for supplies of services and intangibles directly connected with immovable property*

Guideline 3.7

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

3.98 Particular attention to services and intangibles involving immovable property is appropriate as this is a particularly complex area where a specific rule is already applied by many countries. According to this specific rule, taxing rights are allocated to the jurisdiction where the property is located.

3.99 This Guideline does not list particular supplies of services and intangibles that may or may not fall under such a specific rule. Instead, it identifies their common features and establishes categories of supplies of services and intangibles that may be considered to meet the conditions set out in Guideline 3.6 and for which implementation of such a specific rule might therefore be justified.

Circumstances where a specific rule for supplies of services and intangibles directly connected with immovable property may be appropriate

3.100 When internationally traded services or intangibles are directly connected with immovable property, there may be circumstances where the Main Rule does not lead to an appropriate result under the criteria of Guideline 3.6 and where a specific rule allocating the taxing rights to the jurisdiction where the immovable property is located may be appropriate.

3.101 This is most likely to be the case when there is a supply of services or intangibles belonging to one of the following categories:

- the transfer, sale, lease or the right to use, occupy, enjoy or exploit immovable property;
- supplies of services that are physically carried out on immovable property itself, such as constructing, altering and maintaining the immovable property; or
- other supplies of services and intangibles that do not fall within the first two categories but where there is a very close, clear and obvious link or association with the immovable property.

3.102 The second condition for the implementation of a specific rule under Guideline 3.6. requires that such a specific rule would lead to a significantly better result than the Main Rule when evaluated against the criteria of Guideline 3.6. While it is reasonable to assume that this second condition is met for the first two categories of supplies identified above, its fulfilment for the supplies mentioned in the last category above is likely to require an evaluation as set out under Guideline 3.6 before the implementation of a specific rule can be considered.

Common features of supplies of services and intangibles directly connected with immovable property

3.103 The supplies of services and intangibles for which Guideline 3.7 may apply are referred to as *services directly connected with immovable property*. This expression does not have an independent meaning but simply aims to narrow the scope of the specific rule in the sense that it contemplates that there should be a very close, clear and obvious link or association between the supply and the immovable property, and that the specific rule should be applied in a restrictive way. This very close, clear and obvious link or association is considered to exist only when the immovable property is clearly identifiable.

3.104 For the supply to be considered as directly connected with immovable property, it is not sufficient that a connection with immovable property is merely one aspect of the supply, among many others. The connection with immovable property must be at the heart of the supply and must constitute its predominant characteristic. This is particularly relevant in respect of composite supplies involving immovable property. If a connection with immovable property is only one part of the supply, this will not be sufficient for the supply to fall under one of the three categories.

Further description of the supplies of services and intangibles directly connected with immovable property for which a specific rule may be appropriate

3.105 The transfer, sale, lease, or the right to use, occupy, enjoy or exploit immovable property, encompasses all kinds of utilisation of immovable property, i.e. supplies of services and intangibles *derived from* the immovable property (as opposed to other circumstances where the supplies are *directed to* the immovable property). The terms "*transfer*", "*sale*", "*lease*", and "*right to use, occupy, enjoy or exploit*" should therefore not be understood narrowly within the meaning of national civil laws. It should be noted however, that these supplies fall under this Guideline only when they are considered supplies of services or intangibles under national law, i.e. when they are not considered supplies of goods or of immovable property.[41]

3.106 Supplies of services such as the construction, alteration and maintenance of immovable property cover services which are typically physical in nature, as opposed, for example, to intellectual services. Such supplies of services are physically performed on[42] immovable property. These are services that aim to change or maintain the physical status of the immovable property. Typical cases in practice will include, for example, the construction of a building[43] as well as its renovation or demolition, the painting of a building or even the cleaning of it (inside or outside).

3.107 In addition to the utilisation of immovable property and services that are physically performed on immovable property, there may be other supplies of services and intangibles where there is a very close, clear and obvious link or association with immovable property and where taxation in the jurisdiction of the immovable property leads to a significantly better result than the Main Rule when considered under the criteria defined in Guideline 3.6. A specific rule may only be adopted when, in addition to the requirement of a very close, clear and obvious link or association between the supply and the immovable property, it has a sufficiently high potential to be manageable and enforceable in practice. For example, certain intellectual services,[44] such as architectural services that relate to clearly identifiable, specific immovable property, could be considered to have a sufficiently close connection with immovable property.

[41] Other rules will be applicable to such supplies, although they may lead to the same result.

[42] The adverb "on" does not mean that being on land or in/on buildings while the service is performed automatically leads to a service falling under this category (e.g. repairing a movable machine in a factory cannot be considered to be a service performed "on" immovable property and would therefore not be directly connected with immovable property).

[43] If this is not treated as a supply of goods or of immovable property, for which other rules might apply, although they could lead to the same result.

[44] The adjective "intellectual" has a broad meaning and is not limited to regulated professions.

3.4 Business to final consumers ("B2C") supplies

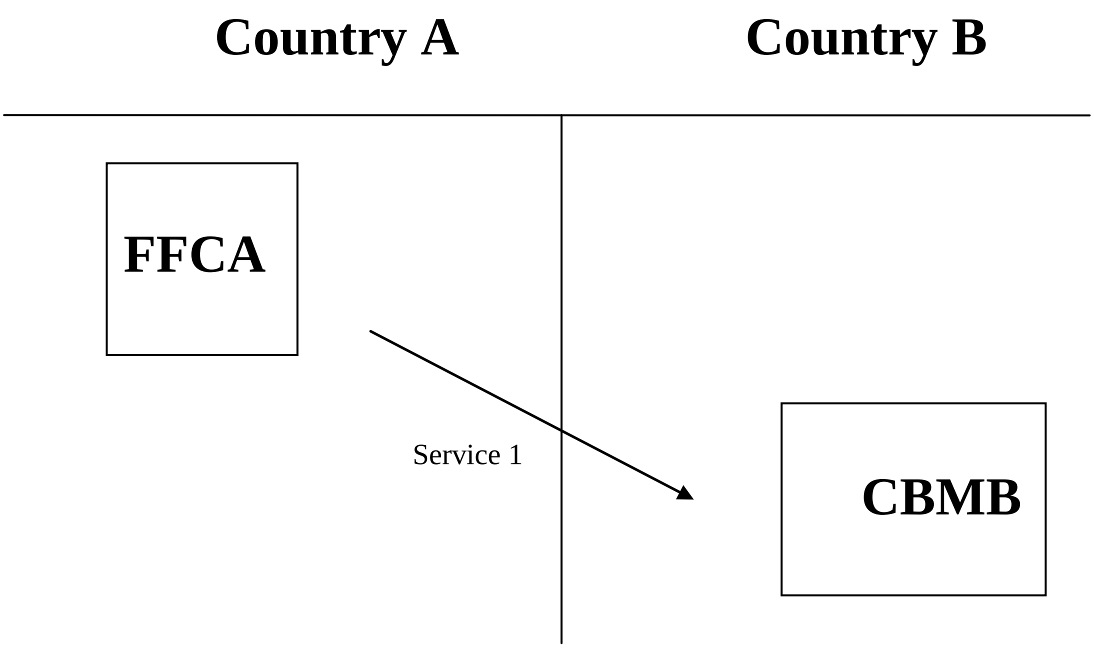
3.108 To be completed at a later stage.

ANNEX 1

EXAMPLES TO ILLUSTRATE THE APPLICATION OF THE GUIDELINES ON PLACE OF TAXATION FOR SUPPLIES OF SERVICES AND INTANGIBLES TO SINGLE LOCATION ENTITIES

The examples in this Annex are illustrative of the principles set out in the Guidelines and consequently are not intended to be exhaustive. The place of taxation of internationally traded services and intangibles will be determined according to the facts of each individual supply.

Example 1: Supply between 2 separate legal entities (whether related by common ownership or not)

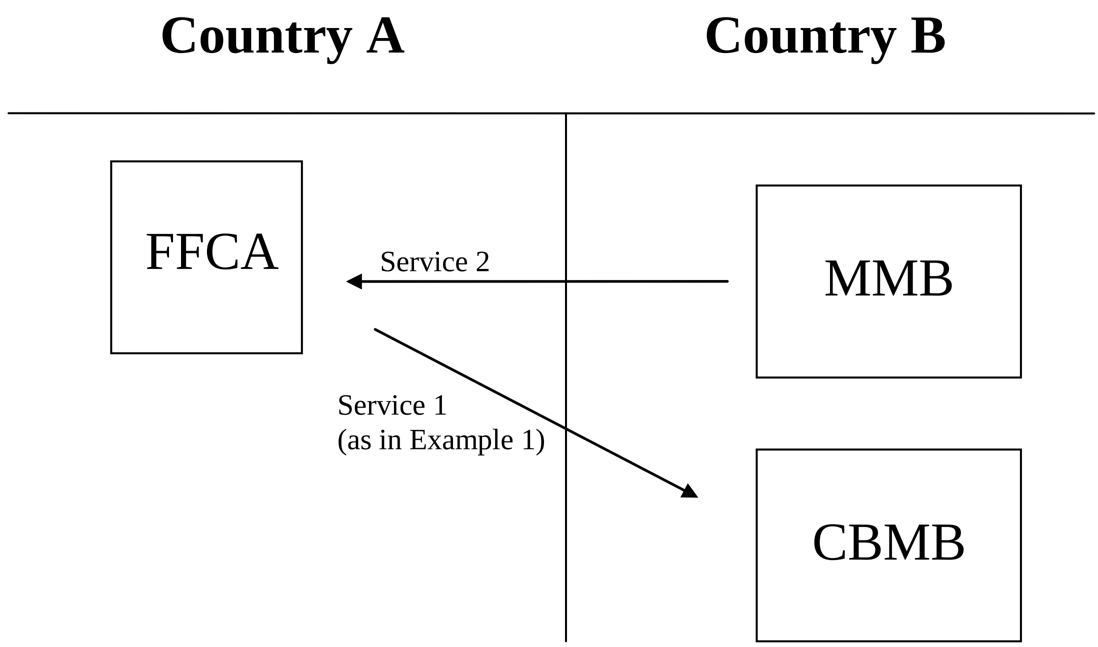


FF Consultancy (FFCA) is a business located in country A specialising in analysing retail food markets, CB Markets (CBMB) is a food retail business located in country B. Neither FFCA nor CBMB have other establishments for VAT purposes. CBMB is considering expanding its retailing activities beyond Country B and approaches FFCA. The two companies enter into a business agreement under which FFCA will provide an analysis of market conditions in Country A to CBMB. CBMB will pay FFCA a sum of money in return for FFCA performing its obligations under this business agreement.

According to the business agreement, FFCA will be the supplier and CBMB will be the customer. There will be a supply of a service provided by the supplier to the customer for consideration. In accordance with the Main Rule, the place of taxation will be country B, which is the country where the customer is located.

Subject to any issues arising from further work, the result remains the same even where the supplier and customer are two separate legal entities related by ownership.

Example 2: Two separate supplies involving three separate legal entities

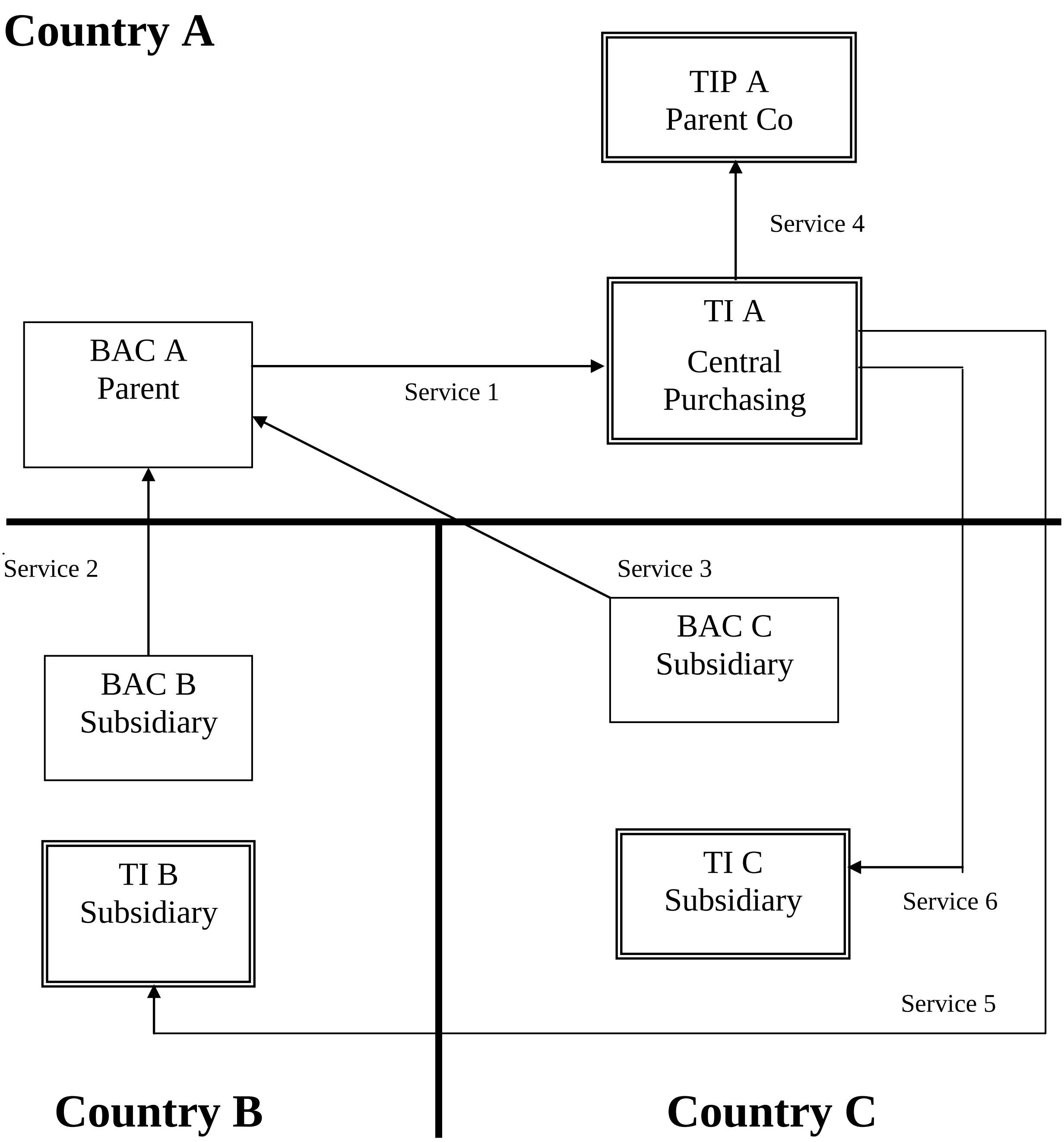


FFCA decides to expand its consultancy activities in Country B. In order to do so it engages the services of a marketing company in Country B – MMB, a company that has no ownership connection with FFCA or CBMB. MMB supplies its services of marketing to FFCA under a business agreement (service 2). The supply of service 1 between FFCA and CBMB (as outlined in Example 1 – analysis of the market conditions in country A) continues as before.

According to the business agreement MMB is the supplier and FFCA the customer. There is a supply of services for consideration. Therefore, in accordance with the Main Rule, the supply by MMB will be subject to taxation in Country A because that is the country where the customer is located. These are two independent supplies and are treated accordingly. The outcome of service 1 as outlined in Example 1 remains unaffected.

Example 3: A global agreement

This example illustrates the supplies that occur when a global agreement for a supply of auditing services is entered into between the parent company of an audit group and a centralised purchasing company of the group requiring audit services for other group members in various countries.



TI A is a centralised purchasing company in country A. It belongs to a multinational company group with subsidiaries around the world, for example in country B, TI B and in country C, TI C. TIP A is the parent company, also located in country A. BAC A is a parent company in country A belonging to a multinational auditing company group with subsidiaries around the world, for example in country B, BAC B; and in country C, BAC C.[45]

TI Group requires a global auditing service to meet legal requirements for the companies in country A and the subsidiaries in countries B and C. The global auditing service is purchased by TI A (for the whole group) which therefore concludes a centralised purchasing agreement with BAC A to supply auditing services to the whole TI Group (including TIP A, TI A, TI B and TI C). Payment will follow each business agreement.

The global auditing service is supplied by BAC A to TI A in return for consideration. This service includes the supply of all components of the global agreement. BAC A is able to actually perform only part of the services itself. The services to TI A and TIP A, which are located in country A, are performed directly by BAC A. However, to be able to fulfil the rest of the agreement, BAC A enters into business agreements with its two subsidiaries, BAC B and BAC C under which BAC B and BAC C supply auditing services to BAC A. BAC B and BAC C provide the services directly to the subsidiaries of TIP A (TI B and TI C). The subsidiaries of TIP A involved, TI B and TI C, are in the same countries as the subsidiaries of BAC A involved in the supplies. TI A enters into separate business agreements with TIP A and the subsidiaries TI B and TI C under which TI A supplies auditing services to TIP A and the subsidiaries TI B and TI C.

There are six separate business agreements in this example, each leading to a supply of a service for consideration. BAC A is the supplier and TI A is the customer under the centralised purchase agreement (service 1). BAC B and BAC C are the suppliers and BAC A is the customer under two different business agreements (service 2 and service 3). TI A is the supplier and TIP A is the customer under a different agreement (service 4). TI A is the supplier and TI B and TI C are the customers under two different business agreements (service 5 and service 6). The place of taxation will be decided for each supply individually.

In accordance with the Main Rule, the place of taxation for the supply of service 1 between BAC A and TI A will be country A as TI A is in country A. In accordance with the Main Rule, the place of taxation for the supply of services 2 and 3 between BAC B and BAC C as suppliers and BAC A as a customer is country A for both supplies. In accordance with the Main Rule the place of taxation for the supply of service 4 between TI A and TIP A will be country A as TIP A is in country A. In accordance with the Main Rule, the place of taxation for the supply of service 5 between TI A and TI B will be country B because country B is the country where the customer is located. In accordance with the Main Rule, the place of taxation for the supply of service 6 between TI A and TI C will be country C because country C is the country where the customer is located.

It should be noted however that, as mentioned above, the performance of these auditing services (which are supplied by BAC B and BAC C to BAC A) is provided directly to TI B and TI C. The fact that the services are *supplied to* someone (BAC A and then on to TI A) different from those (TI B and TI C) to which the services are directly provided is not relevant in this example to determine the place of taxation, as the place of taxation will still be the customer location and not where or to whom the services are directly provided.

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[45] For the purposes of these examples and especially for simplicity and clarity, it is assumed that the auditing group is structured on a parent/subsidiary basis, although it is recognised that this is not normally the case in this sector.

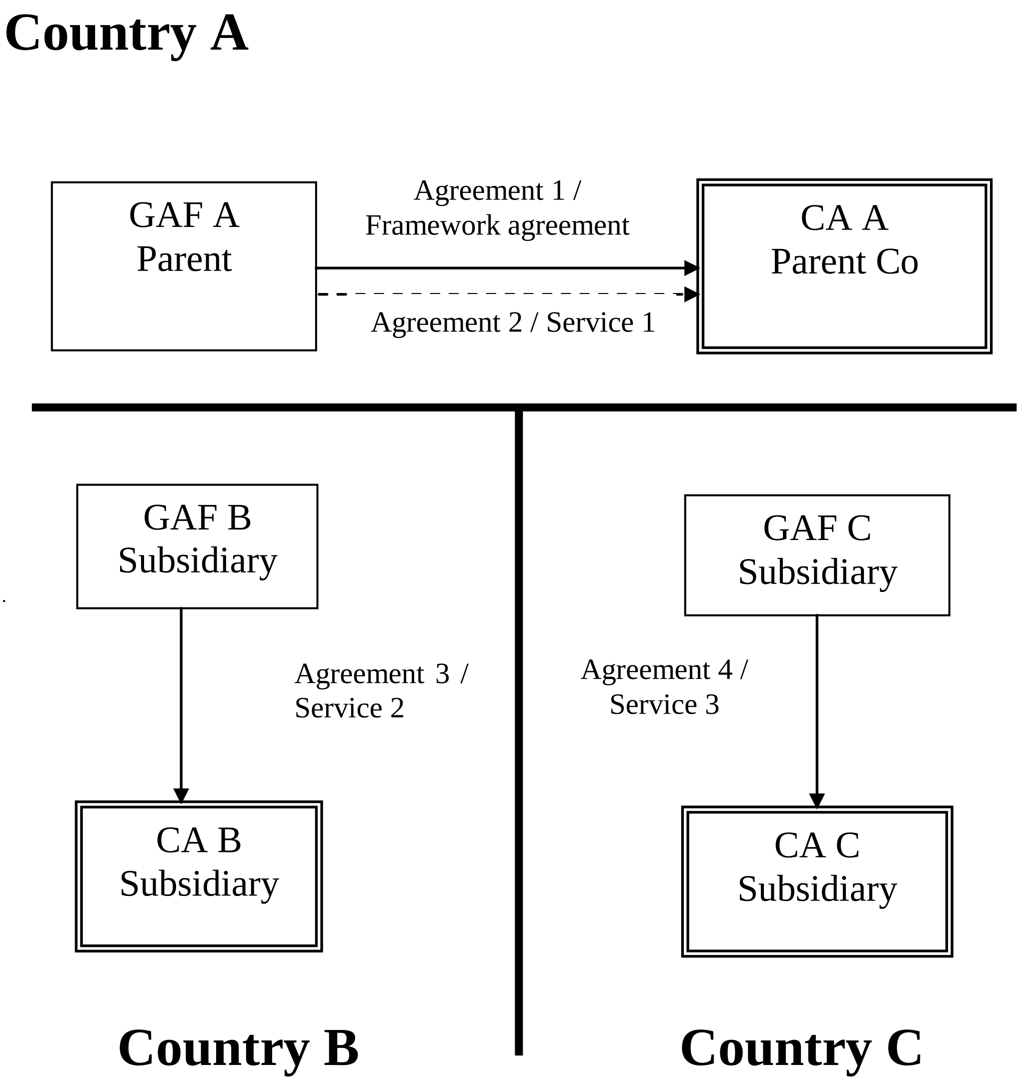
The reason for this is that, at each stage of this example, all supplies will be subject to the taxation rules in the jurisdiction where the customer is located and the services are deemed to be used by the business in accordance with the destination principle as implemented by the Main Rule. There is neither double taxation nor unintentional non-taxation in countries A, B and C. In particular, the tax that accrues to countries B and C reflects the business use of the services in those countries in accordance with the Main Rule that treats customer location as the appropriate proxy for the jurisdiction of business use thereby implementing the destination principle. There is no reason to depart from the business agreements e.g. by following the interaction between BAC B and TI B or between BAC C and TI C.

In developing this example, care has been taken to avoid any stewardship issues that may exist with respect to TIP A. In other words TIP A, as the parent, may also be seen as deriving an element of benefit from the audit activities in countries A, B and C, for example because such audit included an additional review of financial statements under the parent company's country accounting standards, rather than only per local subsidiary country accounting standards. Stewardship issues[46] do not arise in example 3 due to the inclusion of service 4, where TI A supplies auditing services to TIP A. Further, any questions concerning valuation for VAT/GST purposes and the possible identification of supplies existing, other than those shown, are also ignored.

[46] Stewardship expenses are broadly the costs incurred by the parent company of the group for administrative and other services provided to subsidiaries and other affiliates for the benefit of the parent, as a shareholder, rather than for the individual benefit of the subsidiary or affiliate. These costs can be incurred directly by the parent or by the subsidiary and passed on the parent. Typically, these are treated as expenses which ought to be absorbed by the parent company because they must be regarded as stewardship or shareholder's expenses benefiting the shareholder or the group as whole and not a subsidiary or affiliate individually.

Example 4: Alternative global agreement

In this example the parent company of the group requiring audit services enters into a global agreement described as a “framework agreement” with the parent company of the audit group (both in the same country) in order to provide audit services in a number of countries.[47]



CA A is a parent company in country A. It belongs to a multinational company group with subsidiaries around the world, for example in country B, CA B and in country C, CA C. GAF A is a parent company in country A belonging to a multinational auditing company group with subsidiaries around the world for example, in country B, GAF B; and in country C, GAF C.

[47] The expression “*framework agreement*” is used solely to distinguish it from the separate business agreement for audit services to the parent trading company. The Guidelines do not attempt to define in any way what a “framework agreement” might be.

CA Group requires a global auditing service to meet legal requirements for the companies in country A and its subsidiaries in countries B and C. CA A concludes an agreement (i.e. a framework agreement) with GAF A (Agreement 1). The framework agreement covers definitions, obligations relating to confidentiality, warranties, due dates for payment and limitations of liability, that would only apply if and when members of GAF A and CA A enter into separate agreements referring to this framework agreement. The agreement also provides that companies that are affiliated with CA A and the auditing companies that are affiliated with GAF A may enter into business agreements that will incorporate the terms of the framework agreement by reference. The agreement, however, does not oblige any member of CA A group or GAF A group to enter into such business agreements.

CA A enters into a separate business agreement with GAF A for the audit of CA A (Agreement 2); CA B enters into a business agreement with GAF B for the audit of CA B (Agreement 3); and CA C enters into a business agreement with GAF C for the audit of CA C (Agreement 4). In each of these three separate agreements (i.e. Agreements 2-4), an article is included where the parties agree to incorporate the terms included in the framework agreement (Agreement 1). Payment will follow each business agreement.

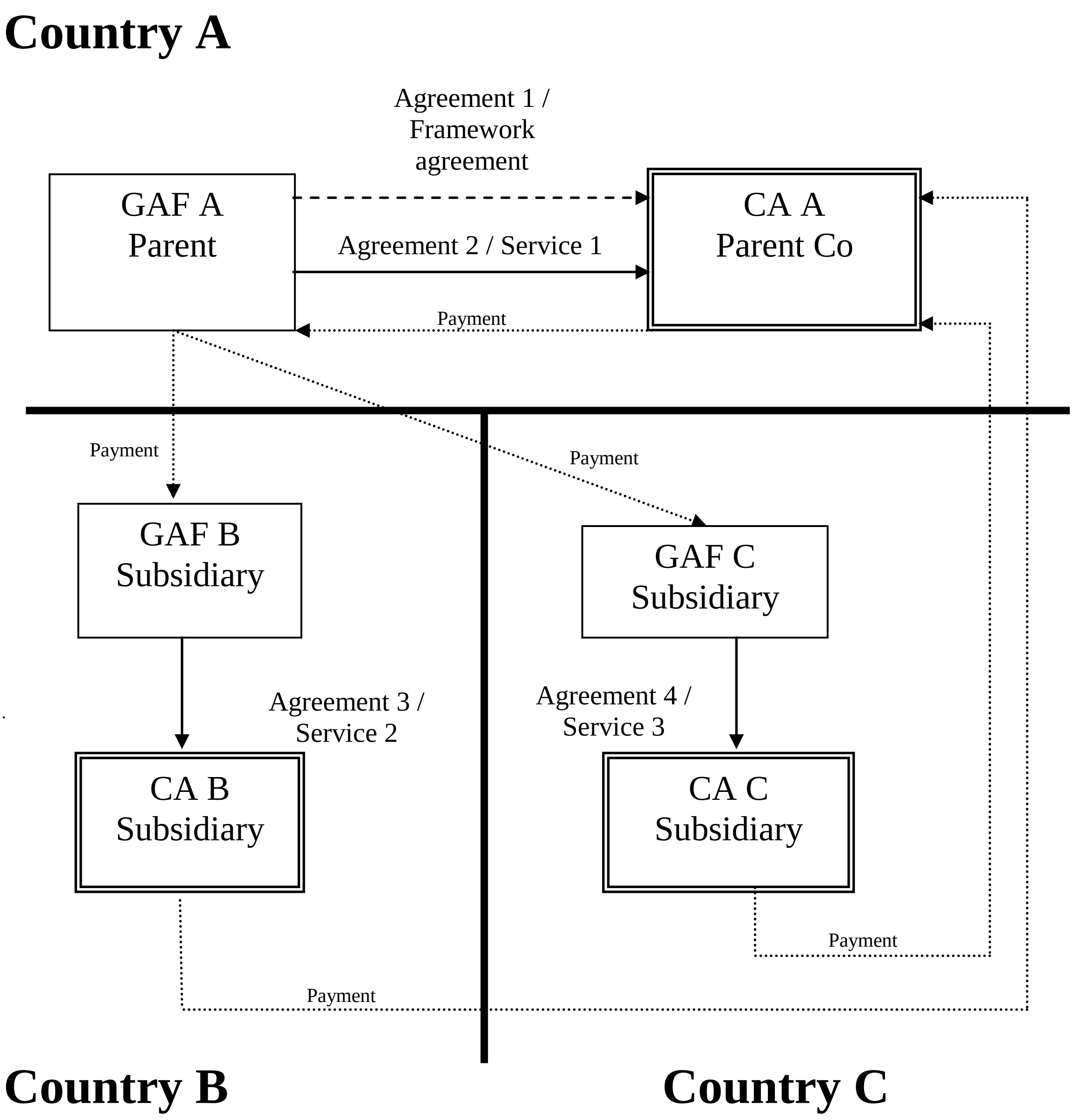
There are four separate business agreements in this example, only three of which lead to a supply of a service for consideration. The first agreement (Agreement 1) is not transactional, has no consideration and does not create a supply. Agreement 1 stipulates terms and conditions that become activated only when parties agree to separate business agreements as specified in the framework agreement. Under the second agreement (Agreement 2), GAF A is the supplier and CA A is the customer (Service 1). Under the third agreement (Agreement 3), GAF B is the supplier and CA B is the customer (Service 2). Under the fourth agreement (Agreement 4), GAF C is the supplier and CA C is the customer (Service 3). The place of taxation will be decided for each supply individually.

In accordance with the Main Rule, the place of taxation for the supply of service 1 between GAF A and CA A will be country A as CA A is in country A. In accordance with the Main Rule, the place of taxation for the supply of service 2 between GAF B and CA B will be country B as CA B is in country B. Further, and again in accordance with the Main Rule, the place of taxation for the supply of service 3 between GAF C and CA C will be country C as CA C is in country C.

All three supplies are subject to the taxation rules in the jurisdiction where the customer is located and is the appropriate proxy for the jurisdiction of business use under the Main Rule. There is neither double taxation nor unintentional non-taxation in countries A, B or C. There is no reason to depart from the business agreements. In particular, no supplies take place under the framework agreement (Agreement 1) itself in this example. Consequently, no supplies are made under that agreement and no place of taxation issue arises.

Example 5*: Alternative global agreement – Different flow of payment*

This example expands upon example 4 by introducing payment flows that are different from the flows of the services as set out in the underlying business agreement.



This example is similar to example 4 except that the CA group has put in place a system for settling inter-company supplies between group members. As a result, the CA group decides to reduce the costs associated with cash disbursements by appointing CA A as the common paymaster for the group.[48] The framework agreement in this example is similar to example 4 except that it specifies that the payments for the services supplied under the locally concluded business agreements will be handled by CA A directly with GAF A for the whole CA group.

For the audit services supplied under the three business agreements GAF A, GAF B and GAF C will follow the general invoicing process and issue invoices respectively to CA A, CA B and CA C. For payment purposes, however, GAF A will issue a collective statement (with copies attached of the invoices issued for the services supplied) to CA A. Based on the collective statement CA A will pay the requested amount to GAF A and will on the same day collect the respective amounts from CA B and CA C. Similarly, GAF A will transfer the respective amounts over to GAF B and GAF C on the same day it receives the payment from CA A.

The movements of payment are simply cash or account entries. The payment CA A makes to GAF A represents consideration for the services supplied from GAF A to CA A, from GAF B to CA B and from GAF C to CA C.

The conclusions reached in example 4 about the place of taxation of the supplies made under the business agreements (Agreements 2, 3 and 4) remain valid. The fact that payments are transferred via CA A and GAF A has no impact on those conclusions.

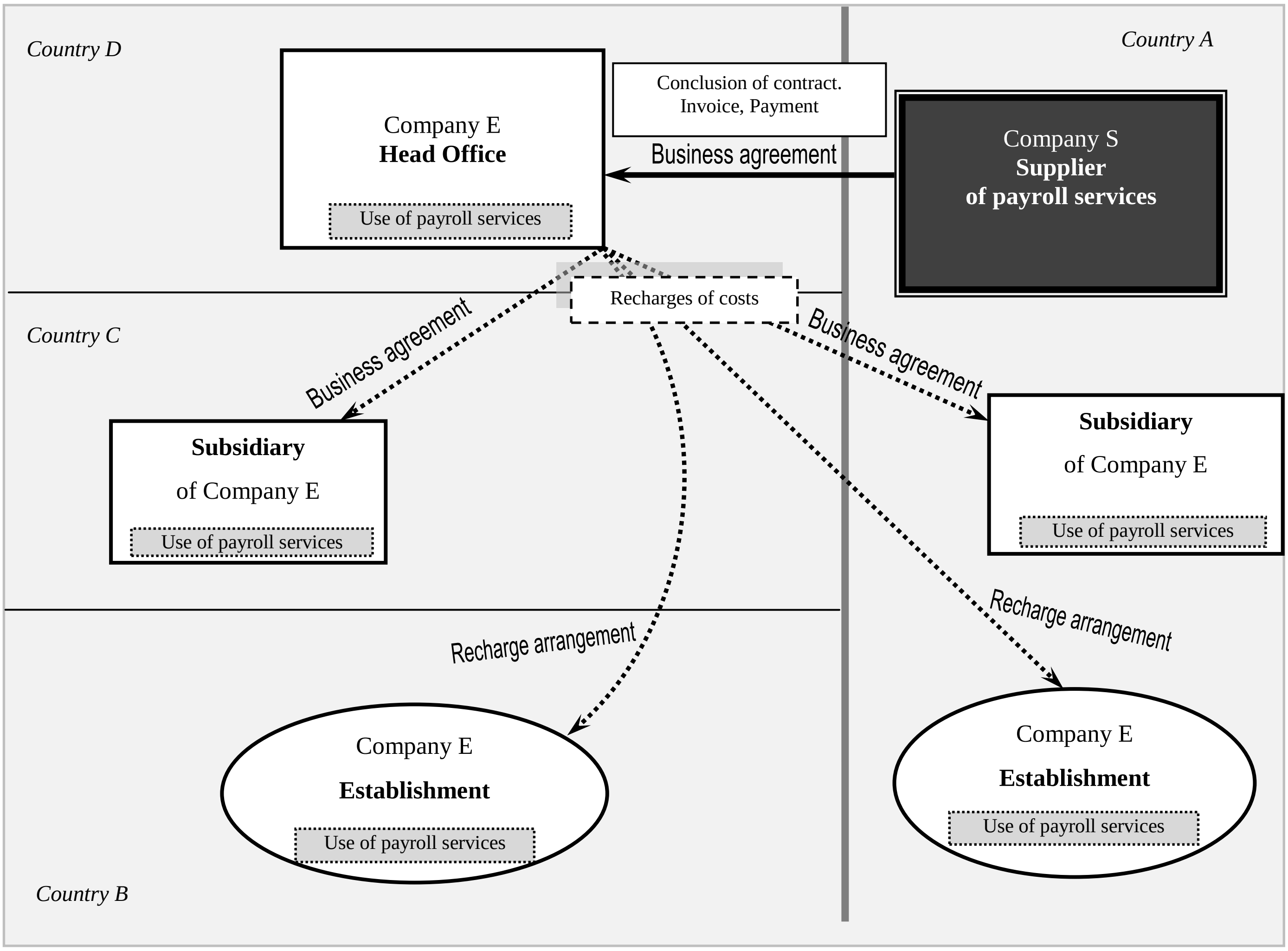
All supplies under the business agreements are subject to the taxation rules in the jurisdiction where the customer is located according to the Main Rule. There is neither double nor unintentional non-taxation in countries A, B or C. There is no reason to depart from the business agreements e.g. by following the cash flows. The cash flows between the CA subsidiaries and CA A, between CA A and GAF A, and between GAF A and the GAF subsidiaries are consideration for services supplied under the business agreements but do not in themselves create additional supplies, nor alter the supplies, nor identify the customer or customer location.

[48] It is recognised that, in some cases, the paymaster function could create a separate supply, or supplies, between CA A and its subsidiaries. For the purposes of this example this is not the case.

ANNEX 2

EXAMPLE TO ILLUSTRATE THE APPLICATION OF THE GUIDELINES ON PLACE OF TAXATION FOR SUPPLIES OF SERVICES AND INTANGIBLES TO MULTIPLE LOCATION ENTITIES

SUPPLY OF PAYROLL SERVICES



Facts

Company E is a multiple location entity located in four different countries: a head office in Country D ("Head Office") and trading establishments ("Establishments") in Countries A and B. It is the parent company of a multinational group with subsidiaries ("Subsidiaries") in Countries A and C. Company E's Head Office and Establishments as well as its Subsidiaries are all registered for VAT purposes.

Company E's Head Office enters into a business agreement with Supplier S, located in Country A, for the supply of payroll management services. In this example, the payroll management services[49] relate to staff of Company E's Head Office and of its Establishments in Countries A and B and its Subsidiaries in Country A and C.

The Head Office of Company E has business agreements in place with its Subsidiaries and recharge arrangements with its Establishments, setting out the terms and conditions for the transactions between them.

The business agreement between Supplier S and Company E establishes a fixed fee per month if the number of employees is within a given range. The fees for the services supplied under this business agreement are paid to Supplier S by Company E's Head Office on receipt of an invoice from Supplier S.

The agreed fee is 20,000. Supplier S issues an invoice for this amount to the Head Office of Company E, from which it receives payment of the entire amount.

Supplier

Supplier S in Country A has entered into a business agreement with Company E. It was negotiated and concluded for Company E by its Head Office in Country D, to which all invoices are addressed and which is responsible for payment. The business agreement provides the evidence allowing the supplier to supply the service free of VAT and to issue an invoice to Company E's Head Office in Country D without VAT.

Customer group[50]

After having entered into the business agreement with Supplier S, the Head Office of Company E will typically have set up this supplier within the "supplier master data" of its ERP system[51] and will have created a cost centre to capture and pool the relevant costs. In this example, the Head Office of Company E has entered into a business agreement to purchase services for its own use and for its Establishments in Countries A and B and its Subsidiaries in Countries A and C. The Head Office of Company E will therefore consider the appropriate methodology for allocating the costs of these services to the Head Office and to its Establishments and Subsidiaries. In this example, the allocation will be based on the number of

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49 Payroll management services include multiple steps such as data collection, master data input in systems, tracking of legislation changes, calculation of taxes, issuance of pay sheets, preparation of accounting entries, preparation of bank transfer files, issue of summary reports, etc.

50 In the context of this example, the term "customer group" refers to Company E and its Establishments and Subsidiaries that employ the staff to which the services supplied by Supplier S relate.

51 Enterprise resource planning (ERP) systems integrate internal and external management flows and information across an entire organisation, embracing finance and accounting functions, manufacturing, sales and services, customer relationship management, etc. ERP systems automate this activity with an integrated software application. Their purpose is to facilitate the flow of information between all business functions within an organisation and to manage the connections to outside stakeholders such as suppliers and customers. See Bidgoli, Hossein, (2004). *The Internet Encyclopedia*, Volume 1, John Wiley & Sons, Inc. p. 707.

employees (or "headcount"). In this case headcount presents a fair and reasonable picture of the use of the payroll management services, by Company E's Head Office and its Establishments and Subsidiaries that employ the staff to which these services relate. Headcount is thus considered as an acceptable cost allocation key for these services.

The terms and conditions for the cost allocations to the Establishments and Subsidiaries will be reflected in business agreements between Company E and its Subsidiaries and in the recharge arrangements between the Head Office of Company E and its Establishments.

Upon receipt of the invoice from Supplier S, the accounts payable team in the Head Office of Company E will enter this invoice into the cost centre for invoices that have to be allocated on the basis of headcount for the onward supplies.

Next, the appropriate VAT treatment ("coding") will be assigned to this entry. This is typically based on a "decision tree", considering the various possible VAT scenarios. The conclusion for Company E's Head Office in this case will be that the invoice received from Supplier S should show no VAT and that the Head Office should account for the VAT in Country D under a reverse charge mechanism.[52] Once approved, the invoice will be processed for payment by the Head Office directly to Supplier S and the Head Office will account for the VAT in Country D under a reverse charge mechanism. Company E's Head Office in Country D will deduct the related input tax in line with its normal right to deduct.

Next, the Head Office of Company E will recharge part of the cost of the payroll services to the Establishments and Subsidiaries that employ the staff to which these services relate. This action is usually part of the regular "accounting close" that would for instance be run at the end of each month, quarter, semester or accounting year. In many cases, this will be done on the basis of an "allocation key table" maintained in the accounting software, highlighting for each account or range of accounts the percentage to be used to allocate the amounts that have been identified for recharge earlier in the process. This close out routine will calculate the amount per Establishment and Subsidiary, produce documentation and place the accounting entries.

In this example, the allocation key is based on headcount. The Head Office of Company E will identify the number of employees on payroll in each of the relevant Establishments and Subsidiaries, typically on the basis of budget data. In this example, budget data show that the Head Office employs 100 staff, the Establishments in Countries A and B employ respectively 10 and 30 staff and its Subsidiaries in Countries A and C respectively have 20 and 40 employees.

The allocation key table will attribute 50% to the Head Office in Country D, 5% to the Establishment in Country A, 15% to the Establishment in Country B, 10 % to the Subsidiary in Country A and 20% to the Subsidiary in Country C. The accounting system at the Head Office of Company E will produce two invoices for the onward supply to its Subsidiaries, one for 2,000 to the Subsidiary in Country A and one for 4,000 to the Subsidiary in Country C.[53] Based on the Main Rule, these invoices will be issued free of VAT since these Subsidiaries are single location entities located outside Country D where the Head Office of Company E is located. The accounting system will also generate two internal documents equivalent to invoices for the allocation of 1,000 to its Establishment in Country A and of 3,000 to its Establishment in Country B. Under the recharge method, these documents will receive the same treatment as if they were

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52 For the purpose of this example, it is assumed that all countries apply a "reverse charge mechanism" that switches the liability to pay the tax from the supplier to the customer. It is recognised that some countries do not require the customer to account for the tax under the reverse charge mechanism when entitled to full input tax credit.

53 See "*Applying the Main Rule – Legal Entities with Single Locations*" paragraphs 3.31 et seq.

invoices to a separate legal entity, and will be issued free of VAT since both Establishments are located outside Country D where the Head Office of Company E is located.

Upon receipt of the invoices, the Subsidiaries in Countries A and C will account for the VAT through the reverse charge. The Establishments in Countries A and B will account for VAT through the reverse charge upon receipt of the documents for the costs allocated to them by their Head Office.

This process will be repeated throughout the accounting year. It may be possible in certain cases that allocation keys would remain unchanged in the course of the accounting year, even if the number of employees by entity would fluctuate during that period. In such a case, companies will typically, at year end, perform a "true up" calculation. The cost allocation will then be reconsidered on the basis of the more precise headcount, taking into account fluctuations in the course of the accounting year. Correcting credit notes or invoices/documents will then be created for the difference between the amount actually charged and the amount as calculated on the basis of actual headcount. These additional invoices or credit notes will follow a VAT treatment similar to the underlying invoices/documents.

Tax administrations

The supplier in Country A should hold all the relevant information that constitutes the business agreement to demonstrate that he has correctly supplied the service free of VAT to Company E's Head Office.

The tax administration in Country D should be able to ensure that the reverse charge is brought to account correctly by Company E's Head Office on the invoice received from Supplier S. It should also be able to ensure a correct tax treatment of the recharges made by Company E's Head Office to its Establishments and Subsidiaries. Company E's Head Office should hold all the relevant information that constitutes the business agreements with Supplier S. It should also hold the business agreements with its Subsidiaries and the recharge arrangements with its Establishments demonstrating how the recharges were allocated.

The tax administrations in Country A, B and C should be able to ensure that the reverse charge is brought to account correctly by the Subsidiaries and Establishments of Company E on the recharges made by the Head Office. The Subsidiaries should hold all the relevant information that constitutes their business agreement with Company E's Head Office and the Establishments should hold the relevant information that constitutes their recharge arrangement with their Head Office. In particular, the tax administrations in Countries A and B should be able to verify that the Establishments have accounted for tax at the correct time of taxation under the normal domestic rules (e.g. date of internal recharge documents, date consideration is paid to the Head Office).

In order to audit the recharges, the tax administrations will need to be able to see all the relevant commercial documentation down to transaction level in order to identify the nature of the individual service that is recharged and so determine its place of taxation and the applicable rate.

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