



OECD INTERNATIONAL VAT/GST GUIDELINES

GUIDELINES ON NEUTRALITY

These Guidelines have been approved by the
Committee on Fiscal Affairs on 28 June 2011

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



CENTRE FOR TAX POLICY AND ADMINISTRATION

INTERNATIONAL VAT/GST GUIDELINES

CHAPTER I

BASIC PRINCIPLES

1. Introduction

1. There are many differences in the way value added taxes (VAT)¹ are implemented around the world and across OECD countries. Nevertheless, there are some common core features that can be described as follows:

- VAT is a tax on consumption paid, ultimately, by final consumers² and collected by businesses.
- The tax is levied on a broad base (as opposed to e.g., excise duties that cover specific products).
- In principle, businesses should not bear the burden of the VAT itself and so there are mechanisms in place that allow for a refund or credit of the tax levied on transactions between businesses³.
- The system is based on tax collection in a staged process, with successive businesses entitled to deduct input tax on purchases and account for output tax on sales. 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. In general, OECD countries with VAT impose the tax at all stages and normally allow immediate deduction of taxes on purchases by all but the final consumer.
- The application of VAT to international trade is based on the destination principle. This means that exports are free of VAT⁴ and imports are taxed on the same basis and at the same rate as local production. This destination principle is sanctioned by World Trade Organization rules⁵.

2. These features give VAT one of its main characteristics, that of neutrality. 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). VAT is neutral in international trade since it is normally destination based⁶ (even if the rule might be different for supplies made within federations or economically integrated areas). This means that exports are free of VAT and imports are taxed on the same

¹ Some jurisdictions cite their form of value added tax as a “Goods and Services Tax” (GST). For ease of reading, all value added taxes will be referred to as “VAT”.

² In this context, “final consumers” include the general public but also various other entities that are involved in non business activities in respect of which there is no right to deduct input tax.

³ Where a business makes exempt supplies or is involved in non business activities, it will normally not be entitled to refunds of tax paid on purchases used to support those activities.

⁴ “Free of VAT” may be termed zero-rated, exempt with credit, or some other local terminology. Whatever the description used, the effect should be the same – no VAT is added by the supplier but the supplier is entitled to input tax credits, to the extent that the jurisdiction allows, in respect of such supplies.

⁵ 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.”

⁶ See IMF Tax Law Drafting Samples: VAT <http://www.imf.org/external/np/leg/tlaw/2003/eng/tlvat.htm> .

basis and at the same rate as domestic supplies. Most of the rules currently in place aim therefore at taxing supplies of goods, services and intangibles⁷ within the jurisdiction where consumption takes place. Practical means of implementing this are, nevertheless, diverse across countries, which can, in some instances, lead to double taxation or unintended non-taxation, and uncertainties for both businesses and tax administrations.

3. VAT should also be administered in a neutral way, in the sense that it should not discriminate between similar businesses and businesses should not bear disproportionate or inappropriate compliance costs that could distort their economic decisions.

4. Although they were designed in the context of e-commerce taxation, the principles in the field of consumption taxes welcomed by Ministers in 1998⁸ remain valid for the more global interaction of consumption tax systems as they broadly reflect the philosophy of the existing tax rules in most countries. These principles can be summarised as follows:

- **Neutrality:** Taxation should seek to be neutral and equitable between forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation;
- **Efficiency:** Compliance costs for businesses and administrative costs for the tax authorities should be minimized as far as possible;
- **Certainty and simplicity:** The 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 accounted;
- **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 counter-acting measures proportionate to risks involved; and
- **Flexibility:** The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

2. Application to International Trade – The Destination Principle

5. The application of the *destination principle* in VAT achieves neutrality in international trade. According to this principle, which is the international norm, exports are exempt with refund of input taxes (that is, free of VAT) and imports are taxed on the same basis and with the same rates as local supplies. This implies that 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. The destination principle contrasts with the *origin principle*⁹, according to which each jurisdiction would levy the VAT on the value created within its own borders. This means that

⁷ Some OECD countries have categories other than goods and services. These cover products such as intellectual property rights and other intangibles. For ease of reference these are referred to as “intangibles”

⁸ 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.

⁹ This should be distinguished from the term used in the EU for a proposed (but never implemented) system in which the VAT would have been collected by the Member State of origin and the revenue later channeled to the Member State of destination for transactions within the EU.

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 one of the core features of 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. In addition, as a neutral tax the total amount of VAT collected should not be influenced by the economic or geographical structure of the value chain. However, under the origin principle this amount reflects the various rates applicable in countries where value is added.

6. In international trade in tangible goods, the destination principle works well because it can be underpinned by frontier or border controls. Exported goods are free of VAT (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. 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. 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.

7. Applying the destination principle to supplies of services and intangible products is more difficult. The nature of services and intangibles is such that there are no customs controls that can confirm their exportation and no customs controls to impose the VAT at importation. Thus, special guidelines have been developed for determining the jurisdiction of taxation for international supplies of services and intangibles that reflect the destination principle (see Chapter II of the Guidelines).

8. Making exports free of VAT and taxing imports introduce a breach in the staged collection process. In most countries where an invoice-credit method is used, tax on services and intangibles supplied from abroad is usually collected by the so-called *reverse charge mechanism*¹⁰. 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. However, the reverse charge mechanism is not applied in all jurisdictions and, where it is implemented, the rules may differ across countries.

2.1. Services and intangibles

9. The destination principle was transposed in the Guidelines as follows:

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

10. Chapter II, Section 1 of the Guidelines provides a set of approaches to enable governments and businesses to implement this principle.

2.2. Goods

11. Paragraph reserved for the principle applicable to international supplies of goods.

12. Chapter II, Section 2 of the Guidelines provides a set of approaches to enable governments and businesses to implement this principle.

¹⁰ The reverse charge mechanism is appropriate for business-to-business supplies and not for business-to-consumers supplies.

3. VAT and Neutrality Principles

13. 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.

14. 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.

3.1. Basic Principles

15. As a starting point, the important principles underpinning neutrality are set out in the introduction in Section 1. In domestic trade, tax neutrality is achieved by the staged payment system: each (fully taxable) business pays VAT to its providers 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 “right” amount of tax to be remitted¹¹ to tax authorities by each business is 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 is entitled to a full right to deduction of input tax, meaning that the tax burden eventually rests with the final consumer rather than the intermediaries in the supply chain.

Guideline 1

The burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation¹².

16. For international trade a core principle is one that the OECD Committee on Fiscal Affairs approved in 2006, and which itself builds on one of the principles set out in paragraph 1, that business should not bear the burden of VAT. The objective is to ensure the tax burden eventually rests with the final consumer rather than the business intermediaries in the supply chain. In this context, the CFA added the following clarification:

“[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.

¹¹ 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 new or developing businesses or seasonality).

¹² This principle was approved by the OECD Committee on Fiscal Affairs in January 2006.

- 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).

For the purposes of these principles however, any such imposition of value added tax on business should be clear and explicit within the legislative framework for the tax”¹³.

Guideline 2

Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation¹⁴.

17. A second principle is set out in paragraph 4, that 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 3

VAT rules should be framed in such a way that they are not the primary influence on business decisions.¹⁵

18. Finally, paragraph 4 also establishes 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).

19. 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.

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

3.2. Neutrality in International Trade

3.2.1. Taxation Principles

21. 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.

¹³ The clarification and examples were provided by the OECD Committee on Fiscal Affairs in January 2006.

¹⁴ Guideline 2 reproduces one of the Ottawa Taxation Framework Conditions, welcomed by Ministers in October 1998.

¹⁵ Guideline 3 is derived from Ottawa Taxation Framework Conditions, welcomed by Ministers in October 1998, which stated that business decisions should be motivated by economic rather than tax considerations.

22. It is particularly important that the application of the rules for international supplies do 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 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.

23. 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 which 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 - see Section 2 above), which ensures that the tax levied on imports does not exceed the amount of 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.

24. The embedded features of the VAT system, combined with the destination principle should ensure the same neutrality for international trade. However, there are inevitably 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.

25. 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 dissuade 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.¹⁶

Guideline 5

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

26. 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.

27. 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;

¹⁶ Reciprocity is an important issue for some countries and will be considered later.

- Making supplies free of VAT;
- Enabling refunds through local VAT registration;
- Shifting of the responsibility on to locally registered suppliers/customers; and
- The granting of purchase exemption certificates.

28. Some countries may adopt only one approach, but others use a combination of different approaches. [Further reference will be inserted here to appropriate guidance]

29. 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 for 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 discrimination¹⁷.

3.2.2. Administration and Compliance

30. 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).

31. Paragraph 18 outlines the principle that VAT considerations should not be the primary driver for business decisions. Paragraph 19 recognises that the VAT considerations go beyond the amount of tax ultimately paid to tax administrations and include the associated costs.

32. The principle that businesses should not incur irrecoverable VAT (except in the circumstances contemplated by paragraph 16) does not mean that compliance costs and burdens should not be borne by businesses. Equally, 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. These issues are covered in more detail in *Consumption Tax Guidance Series Paper n°4 on Foreign Business Service*¹⁸.

Guideline 6

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

¹⁷ Article 24 of the OECD Model Tax Convention on Income and on Capital and its commentary provide some principles, examples and reflections on the concept of non-discrimination.

¹⁸ The Consumption Tax Guidance Series Paper no 4 deals with topics such as foreign business service, availability of information and communication with foreign businesses.

33. 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 Joint Council of Europe/OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters).

34. 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. These issues are covered in more detail in *Consumption Tax Guidance Series*.