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Comments on OECD International VAT/GST Guidelines – Draft Commentary on the International VAT neutrality Guidelines approved in June 2011 ("Draft Commentary")

Dear Mr. Buydens,

We are pleased for the opportunity to submit our comments on the subject matter. The Draft *Guidelines on the International VAT Neutrality* released by the OECD represent a valuable contribution to increase the cohesion and the consistency between countries' VAT system approaches to taxation of international trade services.

Our comments focused on Guidelines 1 and 3. We would be very happy to discuss with you any questions regarding our comments. We can be reached as follows: gaetano.pizzitola@crowehorwath.it; stefania.saccone@crowehorwath.it.

Guideline 1: *The burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation*

Guideline 1 is a key parameter of the fundamental principle of VAT neutrality – i.e., VAT should be neutral in its application through the deduction system for businesses, while its economic burden should fall on the final consumer. In this way, the business is relieved entirely of the burden of the VAT in the course of all economic activities.

With specific regard to cross-border trade, the neutrality of VAT is ensured by the application of the destination principle which provides that internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption.

Guideline 1 specify that *"the application of this principle is, in most cases, best achieved by allocating the taxing rights to the jurisdiction in which the customer is located (the "Main Rule"). As a consequence, these supplies are not taxed in the supplier's jurisdiction but are instead taxed on the same basis and with the same rates as local supplies in the jurisdiction* *of the customer (if VAT is applicable in that jurisdiction)"* through the mechanism of the reverse charge.

In some circumstances, however, the neutrality principle on cross-border trade may be jeopardized where the foreign businesses incur VAT in jurisdictions where they are neither established nor registered. It may happen in scenarios where the foreign businesses incur VAT on services falling within the derogation rules of place of taxation (e.g., Land and Property Services) or, in some instances, in case of differences of rules interpretation between jurisdictions.
This distorts competition between foreign and domestic businesses and, therefore, alternative VAT relief methods should be available for ensuring neutrality.

Although OECD countries have generally implemented different approaches to relieve foreign businesses from or to recover the local VAT (e.g., zero rating provisions, direct refunds, registration), the refund of foreign VAT is still an issue for businesses, especially in this context of financial crisis.
According to the OECD survey conducted in 2010, over 80% of businesses incur more than US$10,000 of VAT on foreign business expenditure every year. The businesses recover 50% or less of this foreign VAT — even when they are entitled to recover it all.[1] In this respect, key factors are communication with the authorities (including guidance, forms, local language and procedures) and speed of repayment.

Indeed, at the EU level, the VAT refund procedures have been largely harmonized with the effect from January 2010 on the basis of new Directive 2008/9/EC of 12 February 2008 with the aim to ensure quicker refunds for claimants by starting the electronic procedure through the tax administration of their country of establishment.

Nevertheless, some EU administrations still take a long time to process refunds by asking, for example, additional documentation and/or information in local language, thereby, the repayments are delayed and the businesses need to outsource these additional requests to external tax advisors for language barriers. This leads additional administrative costs for businesses.
Although we understand that tax administrations may need to take measures to protect tax revenues against fraud and avoidance, standardizing documentation request packages by perhaps also agreeing that documentation in the most common foreign languages in the international business should be acceptable. Besides, tax administrations may identify list of documents that they may obtain directly by the administration of the foreign claimant.

The complexity for businesses to apply in practice the VAT relief methods actually available may generate, in the best-case scenario, a cash flow cost (even though interest may be paid by the administrations making late refunds) or – in the worst-case scenario – a VAT cost. In fact, as mentioned above, it often happens that many businesses do not claim the relief to which they are entitled to, because of the administrative burden and, consequently, the application of the principle under discussion – i.e., that "*the burden of value added taxes themselves should not lie on taxable businesses"* – could *de facto* be threatened.

[1] VAT/GST Relief For Foreign Businesses: The State Of Play, OECD, February 2010

Having said that, we are of the opinion that the VAT overall neutrality on cross-border trade can be actually achieved only by harmonizing the place of taxation rules and by introducing a broader reverse charge mechanism in business to business trade (i.e., abolition of the exceptions to the Main Rule). The introduction of a broader reverse charge mechanism in B2B trade is consistent with the principle of legal certainty, furthermore it reduces the burden on businesses and facilitates the free movement of services with advantage to be also a valid measure to combat VAT frauds.

Additionally, we believe that the achievement of the neutrality also requires further actions on clarification and harmonization of the restrictions rules on the right to deduction. More specifically, we believe that the specification *''except where explicitly provided for in legislation''* in the Guideline under discussion, renders ineffective the principle *"the burden of value added taxes themselves should not lie on taxable businesses"* allowing to the countries' jurisdictions to limit the VAT recover according to the type of supply (financial services, health care, education, culture) and the supplier (holding companies). This happens, for example, when financial businesses are carrying out an exempt activity in Italy that may be subject to VAT under option in Germany - or when businesses purchase supplies for which some countries have implemented specific input tax blocks. These exceptions affect the neutrality of VAT and may create tax cascading effects.

Linked to this, the Guidelines specify that *"when governments do impose a VAT burden on business (...) legislation that so provides should be clear and transparent and should keep compliance costs to a minimum"*. The objective is that the businesses do not unintentionally suffer the cost of VAT and, naturally, we agree with this statement, however, in practice, certain restrictions rules by local legislations may create uncertainty and inconsistencies in the application. For instance, in Italy, VAT is not recoverable on business entertainment costs - as defined for Corporate Income Tax purposes – as a rule, with some specific exceptions.[2] However, from a VAT point of view, uncertainties will arise on the type of expenditures falling within the VAT deductible pool of business entertainment expenses.

In order to overcome actually the tax obstacles in the international trade services and render effective this Guideline, VAT recovery restrictions should be removed in all situations in which the VAT costs relate to the overall taxable economic activities carried out by the businesses. In other words, all input VAT related to costs used for business purposes should be deductible. Alternatively, rather than general restrictions, specific rules may identified that would restrict VAT recovery on expenses to specific categories of VAT payers where the risk of non-business use of expenses may be higher, eg, individual taxable persons or closely-held partnerships and corporations, or even on the basis of other rations such as turnover, number of employees. Furthermore, the development of enhanced tax relationship models may apply VAT restrictions, for example, to companies and enterprises not adopting those tax compliance protocols.

In this context, input VAT blocks (e.g. VAT deduction limitations on cars, fuel, hotels, restaurant and catering services) should also be abolished insofar as they related to business

[2] For example, travel, meals, and accommodation expenses incurred to host potential clients during exhibitions where the goods and services produced by the enterprise are displayed as identified by Ministerial Decree 19 November 2008

use. At least, the harmonization of restrictions rules to common deductible expenditure is needed also to prevent distortions arising from VAT competition between Countries.

Finally, on the last bullet point under paragraph 18 of the Draft Commentary stating that "*input tax recovery is disallowed where explicitly administrative obligations are not met (e.g., insufficient evidence to support input tax deduction)*", we would welcome further analysis and comments to standardize the practice of the various Countries about evidence thresholds. Where different practice arise between Countries, as a matter of fact, such inconsistencies will shift the VAT cost from consumers to businesses. For example, VAT charged by group companies under a cost sharing agreement ("CSA") by applying the reverse charge mechanism has been disregarded by arguing that the economic benefit of the underlying costs were not sufficiently documented. Income tax concepts should not influence on the VAT deduction of CSAs under reverse charge principle and same is true for any transaction subject to reverse charge rule due to its nature. Where subject to double entry in the VAT input and output books such as in Italy, VAT on CSAs and similar transactions should not be claimed against taxpayers booking invoices through reverse charge mechanisms due to their VAT neutrality (exceptions notably arising in the financial industry and a few more) by claiming insufficient documentation tests. Developing specific guidelines on the application of documentation thresholds about reverse charge transactions would prevent the levy on businesses of VAT charges whereby evidence of business use of expenses is by default in the nature of the transaction itself, such as for CSAs and others.

Guideline 3: VAT rules should be framed in such a way that they are not the primary influence on business decisions

Guideline 3 provides that business decisions should be motivated by economic considerations rather than tax ones. Although VAT considerations are likely to be considered when making business decisions (e.g. the amount payable to the tax authority; the compliance burden; the financial costs of the cash-flow impact of the VAT), they should not drive how a business is structured.

The Guidelines specify that *"..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)".*[3]

In this respect, the European Commission highlighted that: "*the current VAT system is based on rather old perceptions of business models and does not sufficiently take account of the way in which operations are structured, particularly cross-border operations, and as a result disproportionate burdens fall on these businesses. It is seen as designed primarily for transactions between un-related parties whereas there is considerable evidence that the*

[3] International VAT neutrality Guidelines adopted in June 2011

greater part of intra-EU operations are now between related entities, both for goods and services."[4]

Indeed, in the last decades, as a result of globalization (new technologies, e-commerce, increasing of competition, new markets, etc.), many multinational companies have changed their way of doing business moving to centralized models with the aim of achieving operational and financial improvements.

Under these models, the economic and commercial risks and key functions are centralized in the so-called "Principal" company, while manufacturing, distribution, and other functions are undertaken in affiliates that bear low risks under outsourcing arrangements such as: toll manufacturing, commissionaire, R&D contract, sales agent and other service contracts.

For example, in the pharmaceutical industry, companies outsource the manufacturing to local entities producing goods in name of and for account of its principal. Similarly for the sales, the companies sell products through local agents managing the client relationship but the sale is made directly by the principal, who will bear the client and receivable risk. The IP is allocated to the Principal.

The change of the business model are primarily for commercial and business reasons. Under these business models, the VAT implications on the cross-border transactions in fact represent a major issue: the Principal may be obliged to register for VAT in most of countries where inventory is held and, thus, it has to process and handle a multiple VAT registrations and reporting obligations.

Furthermore, in Italy, for instances, the Principal (not established in Italy) is constantly in a VAT credit position as result of the "mandatory reverse charge" introduced in February 2010.[5] Under this mechanism all the domestic sales of goods and services performed by non established entities to Italian established customers are subject to reverse charge. Consequently, the non-established entities, even if VAT registered in Italy, are no longer entitled to charge Italian VAT and, as such, they accrue VAT credits on the domestic purchases and importations performed in Italy. This implies further administrative and burden costs for managing refund claims as outlined under Guideline 1.

Mandatory reverse charge rules may create a disproportionate compliance burden for foreign businesses compared to local ones offsetting the input VAT against output VAT. This results in a form of discrimination. We would welcome elective reverse charge mechanisms for foreign businesses that may end up in a recurrent excess VAT credit position due to their local operations. Concerns about VAT abuses may be counteracted through specific protocols to be eligible for ordinary VAT treatment, for example, by allowing for mandatory pre-approval or ruling procedures or, as noted above with respect to VAT deduction on business expenses, by allowing ordinary VAT treatment to multinationals electing for enhanced tax relationship programs in their home countries.

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[4] The summary of the outcome of the public consultation on the Green Paper on the future of VAT towards a simpler, more robust and efficient VAT system of 2 December 2011

[5] Italy has opted for the general reverse charge provided by Article 194 of Directive 2006/112/CE

Within the EU, there is no cash flow impact on toll manufacturers and agent services: both services are generally not subject to local VAT according to the "Main Rule". By contrast, in non-EU countries, different rules apply, e.g., agent services are subject to local VAT in Russia.

VAT implications may also arise in case of toll manufacturing with a limited supply of materials by the Principal. This is due to the lack of a common approach, even within EU, on the qualification of the bundles supplies as supply of services or goods, whose outcome may affect the place of taxation.

By the adoption of new business models, PE claims have increased significantly. The tax administrations have focused the tax audits on restructurings regarding the conversion of local full-fledged subsidiaries into low-risk entities. It is under scrutiny any manufacturer/sales model whereby the local subsidiary acts as a service provider - i.e., including agency and toll manufacturer models.

Although the concept of VAT PE is stricter than the concept applied for the corporate tax purposes, VAT PE in fact should have a minimum size with sufficient human and technical resources in Italy through which it may perform its activity, a PE re-characterization might also lead to the re-establishment of the transaction structure for VAT purposes with the consequent VAT application on all domestic sales plus penalties together with the refusal of VAT refund claim asked as non-established entity.[6]

From a VAT standpoint, new business models should be deemed as "abusive practice" only where the transactions carried out result in the accrual of a tax advantage contrary to the purpose of VAT principles laid down by the EU VAT Directive (e.g. where the structuring results in recoverable input tax by exempt suppliers). Abusive practices should be identified through a number of objective factors proving that transactions have been carried out essentially to take a tax advantage. In this respect, national courts must determine *"whether the activity at issue has some autonomous basis which, if the tax considerations were left aside, is capable of endowing it with some economic justification"*. The EC Court of Justice ruled that, where an abusive practice has been identified, the transactions concerned must be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice.[7] Under the European ECJ approach, input VAT recovery may only be denied in pathological cases of fraud. In this respect, at least at the EU level, there is a need to define clearly the concept of abusive practice and fraud and of bona fide.

In light of above, there are still many VAT issues (administrative burden, lack of harmonization of VAT legislations, PE risk, late VAT refund) that obstacle the development of international trade and the achievement of VAT neutrality. As specified above, new business models take into consideration of the global economy environment changes and

[6] Article 11 of EU Regulation N. 282/2011states that it *"shall be any establishment, other than the place of establishment of a business(...), characterized by a sufficient degree of permanence and a suitable structure in terms of human and technical resources to enable it to receive and use the services supplied to it for its own needs."*
[7] See case C-255/02 *(Halifax)*; case C-223/03 *(University of Huddersfield)*.

therefore VAT systems should be adapted and be more flexible to the commercial developments.

Finally, in that respect, and somehow moving back to our comments about Guideline 1 on CSAs, income tax claims arising from PE challenges to centralized business models should not lead to recharacterization of transactions treated under reverse charge to transactions subject to domestic VAT in all circumstances whereby the overall VAT collection for each single Country would not be impacted. Except for specific cases of VAT abuses, recharacterization of transactions by tax administrations should be prevented from raising material VAT claims in scenarios whereby a domestic VAT charge would not lead to any actual increase of VAT, as it is the case for most B2B local transactions, because businesses have applied reverse charge on the basis of a different interpretation from the one *ex-post* claimed by tax auditors. Whether subject to reverse charge or domestic VAT, many B2B transactions would not lead to any differences on the actual VAT collection other than, perhaps, a temporary one for different VAT positions, debt vs credit, by domestic businesses. Any different practice may indeed jeopardize the primary goal of VAT neutrality.

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Thank you again for the opportunity to participate in the discussion of the subject matter.

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