

## APPLYING VAT/GST TO CROSS-BORDER TRADE IN SERVICES AND INTANGIBLES

## EMERGING CONCEPTS FOR DEFINING PLACE OF TAXATION

Invitation for comments

JANUARY 2008

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



CENTRE FOR TAX POLICY AND ADMINISTRATION



## IMPORTANT NOTICE

*This document has been developed as part of the work of the Working Party N°9 of the Committee on Fiscal Affairs on International VAT/GST Guidelines and relates specifically to the application of VAT/GST to cross-border trade in services and intangibles.*

*It follows work done by a Technical Advisory Group comprising government and business representatives and sets out some of the basic fundamental approaches to applying value added taxes to cross-border supplies of services and intangibles in a business-to-business context.*

*Before continuing its work the Committee considered it necessary to obtain input from the wider business community and from other interested parties. As a first step we are therefore issuing an open invitation to you to contribute to this OECD project by providing us with your experience or comments on a number of basic issues that were identified by the Working Party as essential to the development of its work.*

*Drawing on your comments the Working Party will continue its work, notably as regards the application of the guidelines to more complex situations. An invitation to comment on more complex situations will be issued later this year.*

*The attention of participants is drawn to the fact that this document reflects work in progress and that solutions or conclusions that are presented should not be considered, at this stage, as part of the guidelines. Draft guidelines will be presented for consultation at a later stage as a result of the work of the Committee.*

*This document does not necessarily reflect the views of either the OECD nor of its member countries.*

*We ask you to identify yourself in the questionnaire attached to this document as we may need to follow-up on your responses. Subject to prior authorisation by the commentators, we may publish some of the contributions received on our internet site.*

*Input can be provided by individuals or on a more collective basis by industry bodies or by professional advisory firms. Should you need further information please do not hesitate to contact David Holmes, Head of Consumption Taxes Unit ([David.Holmes@oecd.org](mailto:David.Holmes@oecd.org)) or Stéphane Buydens, Administrator ([Stephane.Buydens@oecd.org](mailto:Stephane.Buydens@oecd.org)).*

*Please send your reply either by mail, fax or e-mail to the following address by 30 April 2008:*

*David Holmes  
Head of Consumption Taxes Unit  
CTP/TAE  
OECD Center for Tax Policy and Administration  
2, rue André Pascal 75775 Paris Cedex 16  
France*

*Fax: +33(0)1.44.30.61.36*

*E-mail: [David.Holmes@oecd.org](mailto:David.Holmes@oecd.org) with copy to [Stephane.Buydens@oecd.org](mailto:Stephane.Buydens@oecd.org)*

## **EMERGING CONCEPTS FOR DEFINING PLACE OF TAXATION FOR CROSS-BORDER SUPPLIES OF SERVICES AND INTANGIBLES**

### **1. Introduction and Background**

1. Value added tax and goods and service tax (hereinafter referred to as VAT/GST) have evolved in a fragmented manner which has resulted in models emerging under which tax is based on different principles in different countries. In itself this does not create taxing tensions and even where goods are traded cross border, principles have emerged which seek to tax only once. The ability to trade services across borders is a more recent development and one which is not always easily assimilated into current models. Historically different principles of taxation - notably origin and destination - can create situations where double taxation or double non-taxation arise.

2. The scope of this paper is limited to VAT/GST taxation of international trade in services and intangibles. As such it does not seek to modify rules for trade within a country or tax system. It does not cover other forms of consumption taxes such as sales taxes or specific service taxes.

3. This paper builds on the following principles, as agreed by the Committee on Fiscal Affairs (CFA) in January 2006<sup>1</sup>:

- For consumption tax purposes internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption;
- The burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation.

4. Further, there is agreement that defining place of taxation under a “pure consumption” test would, in most cases, be impractical and approximations (“proxies”) should be used as practical means for determining the place of consumption. In most situations, the place of consumption should be deemed to be the jurisdiction where the customer is located (“Main Rule”).

5. The aim is to establish how the main rule for the taxation of internationally traded services and intangibles, which ensures that they are not subject to VAT/GST in more than one jurisdiction, should be applied. This application should result in the jurisdiction that has the right to tax the supply deciding whether or not any tax is due. It is recognised that there will be situations where the main rule will not work or where it would not achieve a logical result. In those cases, specific rules will be needed, but these should be limited as far as possible. Such situations may result in the business customer incurring VAT/GST charges in a country other than where it has a taxable presence and as such, provisions will need to be made for refunding VAT/GST where applicable, and for resolving disputes as to which tax regime has the right to receive the VAT/GST.

#### ***Aim of this paper***

6. This paper sets out to explore how the Main Rule might work through a number of relatively simple business scenarios. In doing so, it aims to confirm the way in which the rule works for supplies between separate legal entities (whether related or unrelated according to ownership). At this stage the examples are relatively simple in order to allow a thorough understanding of the way the main rule works. Later papers will consider cases that are more complex and where application of the main rule may be more difficult. The paper takes a step by step approach, building from very simple scenarios and then progressively adding elements of complexity. It recognises that in order to ensure common understanding

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<sup>1</sup> Luxembourg has a reservation on the first principle.

and agreement there are limitations on complexity that need to be observed at this stage. Therefore a number of conditions are applied:

- In each of the scenarios paragraph 2 and the principles in paragraphs 3 and 4 are applied;
- Only business to business supplies are considered<sup>2</sup>;
- Operations in all scenarios are based on and supported by legitimate and bona fide economic substance;
- The scenarios focus on an ideal regulatory environment; existing legislation and practices are ignored; and
- All scenarios are between separate legal entities whether related by common ownership or not.

7. A number of issues have not been dealt with at this stage. These include, for example, fraud and avoidance, distortion of competition, and situations involving businesses with establishments in different countries. These issues will be considered later once the fundamental concepts that emerge from the simple models and examples have been understood and agreed. It may well be that some of the findings of this paper will not be applicable in all situations, for example, fraud, double taxation or unintentional double non-taxation.

## **2. Underlying concepts**

8. VAT/GST is generally charged at all stages of the economic process, but with the provision of a mechanism enabling firms to offset the tax they pay on their own purchases of goods and services (input tax) against the tax they charge on their sales of goods and services (output tax). Accordingly, most businesses can recover all, or most, of the input tax they pay as an offset against the output tax they charge. However, customers who are not identified for VAT/GST, or are not required to be so identified and report (e.g., businesses below the turnover thresholds that apply in some countries or private consumers), cannot recover the tax. Moreover, under most VAT/GST systems even businesses identified for VAT/GST or suppliers that make supplies of goods or services that are exempt from VAT/GST can recover input tax only to the extent that they also make taxable supplies. Similarly, as a matter of tax policy, some systems deny or restrict recovery of input tax incurred on particular expenditures e.g. cars or business entertainment, to reflect non-business or private use. This unrecoverable tax is an intentional part of the VAT/GST system. Customers to which recovery of input tax is denied in such circumstances are treated as if they are final consumers.

9. The main rule defines the place of taxation on the basis of customer location and in normal circumstances should be applied to determine the place of taxation. The identity and the jurisdiction where the customer to which the supply is made is located will then be normally supported by the relevant business agreement<sup>3</sup>, as it is expected that business agreements generally reflect the underlying transactions and financial flows. Only in specified or exceptional circumstances should the place of taxation vary from the main rule.

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<sup>2</sup> Cross-border supplies to businesses and organisations not required to identify and report for VAT/GST purposes (in countries that have a VAT or GST system that requires identification) will be considered later as these raise specific issues.

<sup>3</sup> For the purposes of this paper and the simple examples considered, “business agreement” is taken to mean any agreement, regardless of form, between persons acting in a business capacity that underlies the provision of a supply. (In most cases, documentation will reflect the existence of the business agreement.)

10. For VAT/GST, a number of factors must exist before the tax can be charged in a particular place. There has to be, for example, a supplier, a customer, a supply and a place of taxation rule to determine the jurisdiction in which any tax should accrue. To ensure that the basic principles of neutrality, efficiency, flexibility, certainty and simplicity are achieved these, and some other, terms will need to be defined at a later stage, drawing on the lessons learned from the development of these business models and examples.

11. As a first step, it was agreed that the development of guidance on how to implement the main rule in practice should start by the examination of a selection of basic concepts as listed above (i.e. supplier, customer, supply) on the basis of simple practical examples, involving simple supplies.

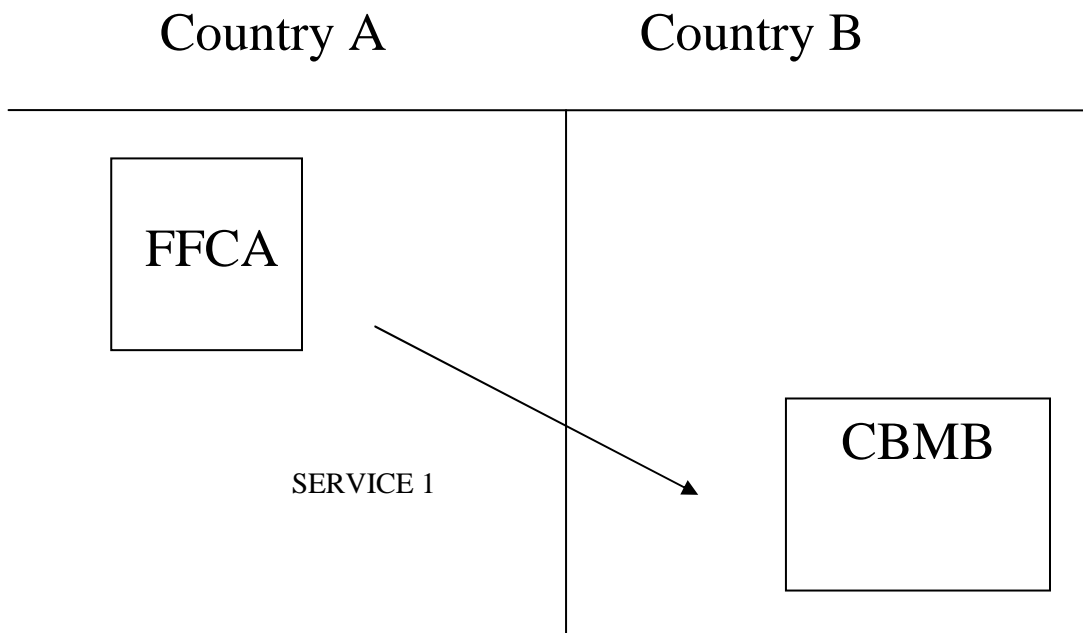
### **3. Tax Collection Mechanisms**

12. It is recommended that the business customer should account for VAT/GST, where applicable, on cross-border business-to-business (B2B) transactions using the reverse charge, self-assessment or tax shift mechanism (hereinafter reverse charge mechanism), as far as this type of mechanism is consistent with the overall design of the national consumption tax system. Once the place of taxation is determined, the country that has the right to tax the supply decides whether any tax is actually due. For example, countries may wish to consider dispensing with the requirement to reverse charge the tax in circumstances where the customer would be entitled to fully recover it through deduction or input tax credit. However, the examples that follow assume use of this mechanism as the means of accounting for the tax. There may well be issues connected to reverse charge that will need addressing at a later stage, but for the moment the working assumption is that this mechanism is appropriate.

13. In these circumstances the reverse charge mechanism has a number of key advantages. Firstly, the tax authority in the country of consumption can verify and enforce compliance since that authority has jurisdiction over the customer. Secondly, the compliance burden is shifted from the supplier to the customer and is minimised since the customer has full access to the details of the supply. Thirdly, the compliance costs for the tax authority are also low because the supplier is not required to meet tax obligations in the customer's country (e.g. VAT/GST identification, audits, which would otherwise have to be administered). 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 tax or recover it through input tax credits.

4. Applying the Concepts to a practical case

*Step 1: Transaction between 2 separate legal entities (whether related by common ownership or not):*

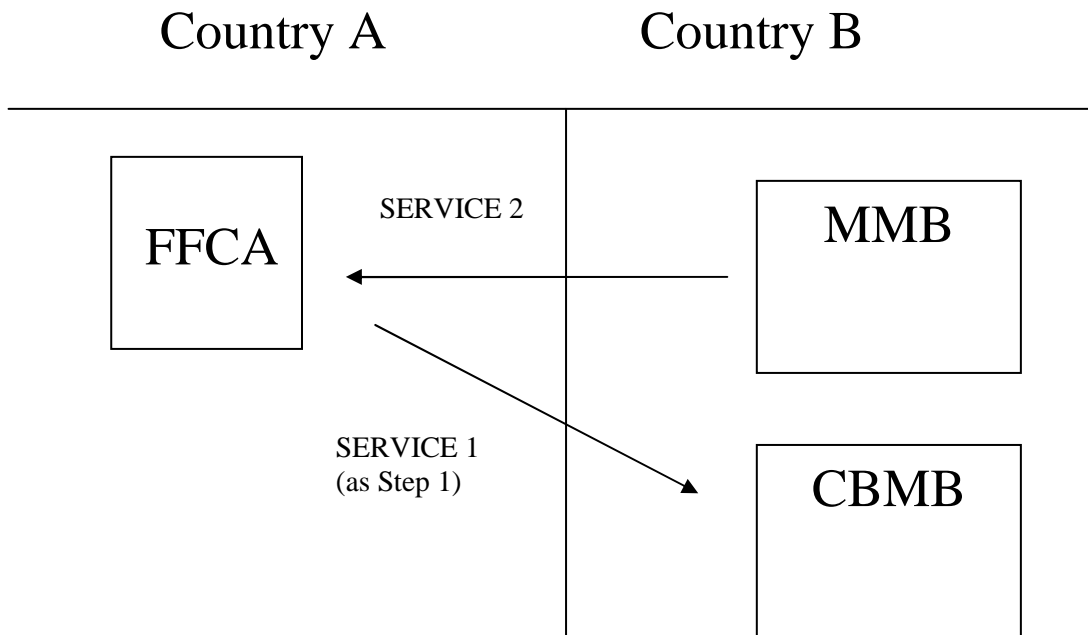


14. FF Consultancy (FFCA) is a business located in country A specialising in analysing retail food markets, CB Markets (CBMB) is a food retail business located in country B. Neither FFCA nor CBMB have other establishments for VAT/GST purposes. CBMB is considering expanding its retailing activities beyond 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.

15. 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.

16. 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, .

*Step 2: Two separate Transactions involving three separate legal entities.*

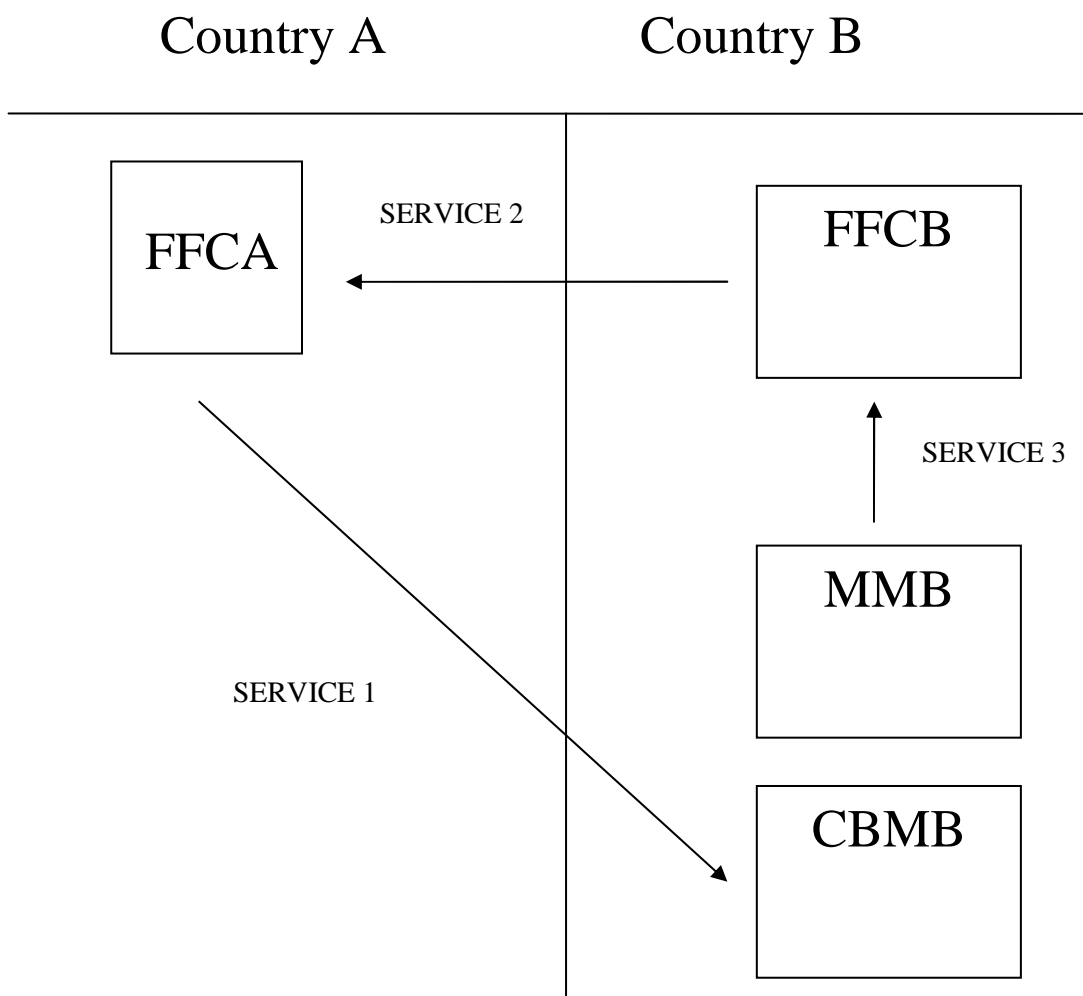


17. FFCA decides to expand its consultancy activities in Country B. In order to do so it engages the services of a marketing company in Country B – MMB, a company that has no ownership connection with FFCA or CBMB. MMB supplies its services of marketing to FFCA under a business agreement (service 2).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

18. 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 step 1 remains unaffected.



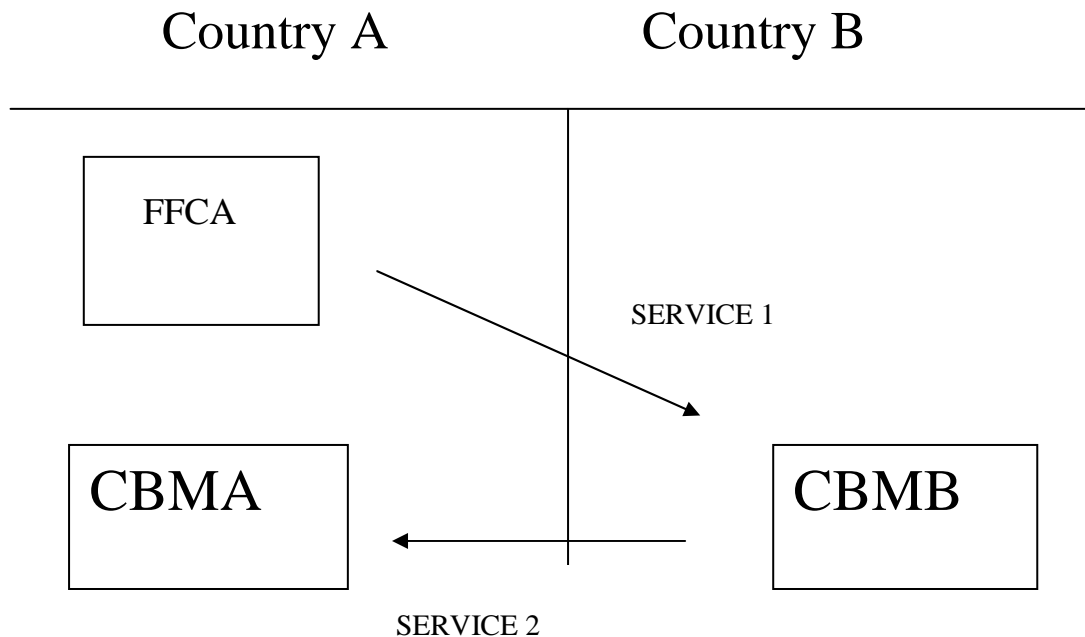
*Step 3: Transactions involving a third party*



19. As FFCA's activities in Country B grow it decides to create a wholly-owned subsidiary in Country B to carry out the marketing activities (FFCB). However, from time to time and in order to provide its marketing services to its parent company in Country A, FFCB decides to buy in some marketing services from MMB (see Step 2). There is a business agreement between FFCB and MMB for these services. There is also a business agreement between FFCA and FFCB under which FFCB provides all marketing services in Country B to FFCA for consideration. The supply of service 1 between FFCA and CBMB (as outlined in step 1 – analysis of the market conditions in country A) continues as before.

20. There are now three individual supplies of services, all for consideration. The service provided by MMB to FFCB (service 3) will be a domestic supply in Country B and would be subject to tax in Country B. Applying the main rule, the onward supply of these services from FFCB to FFCA (service 2) will be subject to tax in Country A. The place of taxation will not be influenced by any subsequent supply or lack of such supply between CBMB and FFCA. The outcome of service 1 as outlined in step 1 remains unaffected.

*Step 4: Transactions involving a customer group*



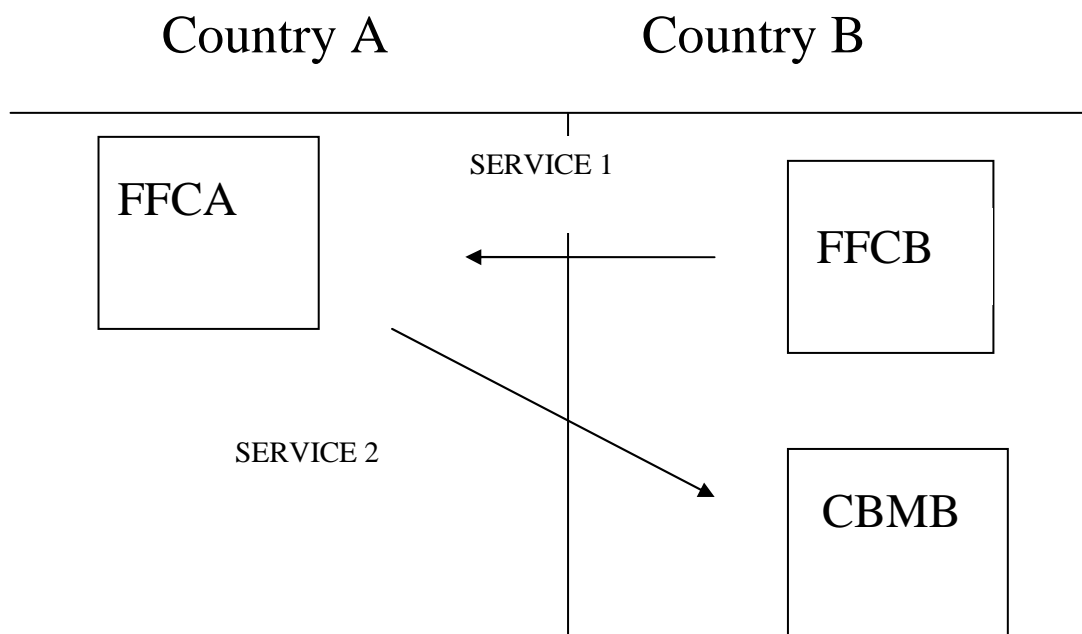
21. CBMB's business is growing and it decides to create a new company (CB Markets A, a separate legal entity) in country A. CB Markets A (CBMA) is wholly owned by CB Markets in country B (CBMB). CBMA needs specific information to conduct its business and enters into a business agreement with CBMB in which CBMB agrees to provide the relevant information in a report to CBMA. CBM Group has centralised analytical and data-gathering activities in one central site (at CBMB) in Country B. Under this agreement, CBMA will pay CBMB for this service. In order to fulfil its obligations towards CBMA, CBMB enters into a business agreement with FFCA similar to that in Step 1, except that this agreement now specifies that CBMB is permitted to disclose or re-sell the report. There are no business agreements between FFCA and CBMA<sup>4</sup>.

22. There are two separate business agreements in this example, each leading to a supply of a service for consideration. FFCA is the supplier and CBMB is the customer under one of the agreements (service 1) and CBMB is the supplier and CBMA is the customer under the other agreement (service 2). The place of taxation will be decided for each supply individually so that the determination of the place of taxation of service 1 for VAT/GST purposes will not be influenced by any subsequent supply or lack of such supply between CBMB and CBMA. In accordance with the main rule, the place of taxation for the supply of service 1 between FFCA and CBMB will be country B because country B is the country of the customer. In accordance with the main rule the place of taxation for the supply of service 2 between CBMB and CBMA will be country A because country A is the country where the customer is located.

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Situations in which an intentional or unintentional relationship is created between FFCA and CBMA (such as delivery of report or other activities) will be dealt with later as part of more complex models.

*Step 5: Transactions involving a supplier group*



23. Step 4 had a customer group (CBMA and CBMB) but in this example there is a supplier group (FFCA and FFCB). FFCA expands its operations and asks FFCB to undertake other activities in addition to marketing services. FFCB enters into a business agreement with FFCA under which it will provide data gathering services to FFCA. The data received from FFCB will be analysed by FFCA in its offices in country A and will be used by FFCA in the course of its supply of overall consultancy services (analysis of market conditions in country B) to CBMB under its business agreement with CBMB. FFCA will receive payment from CBMB for the consultancy services supplied to CBMB under the business agreement with CBMB. FFCB will receive payment from FFCA for the data gathering services supplied under the business agreement between FFCA and FFCB<sup>5</sup>.

24. FFCB is the supplier and FFCA is the customer under one of the agreements (service 1) and FFCA is the supplier and CBMB is the customer under the other agreement (service 2). There are therefore two separate supplies of services, both for consideration. In accordance with the main rule, the place of taxation for the supply between FFCB and FFCA will be country A because country A is the country where the customer is located. In accordance with the main rule, the place of taxation for the supply between FFCA and CBMB will be country B because country B is the country where the customer is located. The place of taxation will be decided for each supply individually. The fact that CBMB knows that FFCB has collected data from country B and has contributed to the supply of the final service does not impact the determination of the place of taxation: the business agreement should be followed.

<sup>5</sup> Situations in which an intentional or unintentional relationship is created between FFCB and CBMB (such as delivery of report or other activities) will be dealt with later as part of more complex models.

## Summary of work to date

**25. The examples illustrate that, in practical terms, the result of the main rule is that the jurisdiction where the customer is located, as normally supported by the business agreement, has the taxing rights over a service or intangible supplied across international borders.** This principle should be applicable in the following way:

- The place of taxation should be decided for each supply individually so that the determination of the place of taxation of a service or intangible for VAT/GST purposes will not be influenced by any subsequent supply or lack of such supply;
- This normally remains the case whether or not the two parties to a transaction are related in terms of ownership and control;
- A business in the customer's jurisdiction which is related through common ownership to the supplier does not affect these conclusions as long as there is no supply from that business to this customer;
- Similarly, a business in the supplier's jurisdiction which is related through common ownership to the customer does not affect these conclusions as long as there is no supply from the supplier to that business.

**ANNEX 1**  
**INVITATION TO COMMENT ON PLACE OF TAXATION**  
**CONTACT INFORMATION**

**Contact for follow-up:**

Name:

Organisation:

Country:

E-mail address:

Telephone:

Fax:

Please indicate whether you are responding to this questionnaire :

- As an academic or student
- As a corporate taxpayer
- On behalf of other taxpayer(s) (e.g. advisory firm, law firm, business association, etc.)
- Other (please specify)

Where you are replying on behalf of others please construe the term “you” to mean “your organisation” or “your clients” as appropriate.

Do you authorize the OECD to publish your contribution on our internet site?

- Yes
- No