Chapter 2

Fundamental principles of taxation

This chapter discusses the overarching principles of tax policy that have traditionally guided the development of tax systems. It then provides an overview of the principles underlying corporate income tax, focusing primarily on the taxation of cross-border income both under domestic laws and in the context of tax treaties. Finally, it provides an overview of the design features of value-added tax (VAT) systems.

2.1 Overarching principles of tax policy

In a context where many governments have to cope with less revenue, increasing expenditures and resulting fiscal constraints, raising revenue remains the most important function of taxes, which serve as the primary means for financing public goods such as maintenance of law and order and public infrastructure. Assuming a certain level of revenue that needs to be raised, which depends on the broader economic and fiscal policies of the country concerned, there are a number of broad tax policy considerations that have traditionally guided the development of taxation systems. These include neutrality, efficiency, certainty and simplicity, effectiveness and fairness, as well as flexibility. In the context of work leading up to the Report on the Taxation of Electronic Commerce (see Annex A for further detail), these overarching principles were the basis for the 1998 Ottawa Ministerial Conference, and are since then referred to as the Ottawa Taxation Framework Conditions. At the time, these principles were deemed appropriate for an evaluation of the taxation issues related to e-commerce. Although most of the new business models identified in Chapter 4 did not exist yet at the time, these principles, with modification, continue to be relevant in the digital economy, as discussed in Chapter 8. In addition to these well-recognised principles, equity is an important consideration for the design of tax policy.

- **Neutrality:** Taxation should seek to be neutral and equitable between forms of business activities. A neutral tax will contribute to efficiency by ensuring that optimal allocation of the means of production is achieved. A distortion, and the corresponding deadweight loss, will occur when changes in price trigger different changes in supply and demand than would occur in the absence of tax. In this sense, neutrality also entails that the tax system raises revenue while minimising discrimination in favour of, or against, any particular economic choice. This implies that the same principles of taxation should apply to all forms of business, while addressing specific features that may otherwise undermine an equal and neutral application of those principles.

- **Efficiency:** Compliance costs to business and administration costs for governments should be minimised as far as possible.

- **Certainty and simplicity:** Tax rules should be clear and simple to understand, so that taxpayers know where they stand. A simple tax system makes it easier for individuals and businesses to understand their obligations and entitlements. As a result, businesses are more likely to make optimal decisions and respond to intended policy choices. Complexity also favours aggressive tax planning, which may trigger deadweight losses for the economy.

- **Effectiveness and fairness:** Taxation should produce the right amount of tax at the right time, while avoiding both double taxation and unintentional non-taxation. In addition, the potential for evasion and avoidance should be minimised. Prior discussions in the Technical Advisory Groups (TAGs) considered that if there is a class of taxpayers that are technically subject to a tax, but are never required to pay the tax due to inability to enforce it, then the taxpaying public may view the tax as unfair and ineffective. As a result, the practical enforceability of tax rules is an important consideration for policy makers. In addition, because it influences the collectability and the administerability of taxes, enforceability is crucial to ensure efficiency of the tax system.
- **Flexibility:** Taxation systems should be flexible and dynamic enough to ensure they keep pace with technological and commercial developments. It is important that a tax system is dynamic and flexible enough to meet the current revenue needs of governments while adapting to changing needs on an ongoing basis. This means that the structural features of the system should be durable in a changing policy context, yet flexible and dynamic enough to allow governments to respond as required to keep pace with technological and commercial developments, taking into account that future developments will often be difficult to predict.

Equity is also an important consideration within a tax policy framework. Equity has two main elements; horizontal equity and vertical equity. Horizontal equity suggests that taxpayers in similar circumstances should bear a similar tax burden. Vertical equity is a normative concept, whose definition can differ from one user to another. According to some, it suggests that taxpayers in better circumstances should bear a larger part of the tax burden as a proportion of their income. In practice, the interpretation of vertical equity depends on the extent to which countries want to diminish income variation and whether it should be applied to income earned in a specific period or to lifetime income. Equity is traditionally delivered through the design of the personal tax and transfer systems.

Equity may also refer to inter-nation equity. As a theory, inter-nation equity is concerned with the allocation of national gain and loss in the international context and aims to ensure that each country receives an equitable share of tax revenues from cross-border transactions (OECD, 2001). The tax policy principle of inter-nation equity has been an important consideration in the debate on the division of taxing rights between source and residence countries. At the time of the Ottawa work on the taxation of electronic commerce, this important concern was recognised by stating that "any adaptation of the existing international taxation principles should be structured to maintain fiscal sovereignty of countries, […] to achieve a fair sharing of the tax base from electronic commerce between countries…" (OECD, 2001: 228).

Tax policy choices often reflect decisions by policy makers on the relative importance of each of these principles and will also reflect wider economic and social policy considerations outside the field of tax.

2.2 Taxes on income and consumption

Most countries impose taxes on both income and consumption. While income taxes are levied on net income (i.e. from labour and capital) over an annual tax period, consumption taxes operate as a levy on expenditure relating to the consumption of goods and services, imposed at the time of the transaction.

There are a variety of forms of income and consumption taxes. Income tax is generally due on the net income realised by the taxpayer over an income period. In contrast, consumption taxes find their taxable event in a transaction, the exchange of goods and services for consideration either at the last point of sale to the final end user (retail sales tax and VAT), or on intermediate transactions between businesses (VAT) (OECD, 2011), or through levies on particular goods or services such as excise taxes, customs and import duties. Income taxes are levied at the place of source of income while consumption taxes are levied at the place of destination (i.e. the importing country).

It is also worth noting that the tax burden is not always borne by those who are legally required to pay the tax. Depending on the price elasticity of the factors of production (which in turn depends on the preferences of consumers, the mobility of factors of production, the degree of competition etc.), the tax burden may be shifted and thus both income and consumption taxes can have a similar tax incidence. In general, it is said that the tax incidence falls upon capital, labour and/or consumption. For example, if capital were more mobile than labour and the market is a highly competitive and well-functioning one, most of the tax burden would be borne by workers.

2.3 Corporate income tax

Although the tax base can be defined in a great variety of ways, corporate income tax (CIT) generally relies on a broad tax base, formulated to encompass all types of income derived by the corporation whatever their nature,[1] which encompasses the normal return on equity capital in addition to what can be described as "pure" or "economic rents" i.e. what the enterprise earns from particular competitive advantages which may be related to advantageous production factors (such as natural resources that are easily exploitable or low labour costs) or advantages related to the market in which the products will be sold (e.g. a monopolistic position).

At the time CIT systems were introduced, one of their primary objectives was to act as a prepayment of personal income taxes due by the shareholders (i.e. the "gap-filling" function (Bird, 2002), also referred to as the "deferral justification"), thereby preventing potentially indefinite deferral of personal income tax (Vann, 2010). As a result, the corporate tax base was seen as a proxy for the return on equity capital. It follows that corporate taxes are generally imposed on net profits, that is receipts minus expenses. Two basic models, different in their approach but similar in their practical result, are used to assess this taxable income:

- The receipts-and-outgoings system (or profit & loss method): net income is determined as the difference between all recognised income derived by a corporation in the tax period and all deductible expenses incurred by the corporation in the same tax period.
- The balance-sheet system (or net-worth comparison method): net income is determined by comparing the value of the net assets in the balance sheet of the taxpayer at the end of the tax period (plus dividends distributed) with the value of the net assets in the balance sheet of the taxpayer at the beginning of the tax period.

Some countries have achieved substantial uniformity, except for some differences where the accounting treatment may be vulnerable to manipulations intended to distort the measurement of taxable income (e.g. denial of deduction of certain expenses, different method of recognition of capital expenditures, different timing in recognition of gains on certain fixed assets). In other countries tax and financial accounting are substantially independent, with tax law provisions addressing to a large extent the treatment of the transactions entered into by a corporation.

2.3.1 The taxation of cross-border income under domestic corporate income tax laws

It is commonly accepted that there are two aspects to a state's sovereignty: the power over a territory ("enforcement jurisdiction") and the power over a particular set of subjects ("political allegiance"). This binary nature of sovereignty was strongly rooted in the minds of the people during the 19th and 20th century and exercised a significant influence in the fashioning of one State's jurisdiction to tax. Conscious that taxes ought to be confined to taxable subjects and objects that have some sort of connection with the imposing State, policy makers reached the conclusion that a legitimate tax claim ought to be either based on the relationship to a person (i.e. a “personal attachment”) or on the relationship to a territory (i.e. a “territorial attachment”) (Schon, 2010; Beale, 1935).

Along the same line, the dual nature of sovereignty has also contributed to the formulation of the realistic doctrine, which is driven by concerns for the enforcement, administration, collection of taxes and came to limit the traditional notion of sovereignty (Tadmore, 2007). While a state’s right to levy income taxes relies on territory or residence, the realistic doctrine advances that without the power to tax, there is no jurisdiction to tax and is more concerned with the exercise of taxing rights by the State in an effective manner (Tadmore, 2007). Under the realistic doctrine, a distinction is made between jurisdiction to impose taxes and jurisdiction to enforce them, also called “the enforcement jurisdiction” (Hellerstein, 2009) and emphasis is placed on practicality over theory.

Domestic tax rules for the taxation of cross-border income generally address two situations: the taxation of outbound investments of resident companies, and the taxation of inbound investments of non-resident companies. With respect to the former category, the definition of residence is a key notion. Some countries determine the residence of a corporation based on formal criteria such as place of incorporation. In other countries, the residence of a corporation is determined by reference factual criteria such as place of effective management or similar concepts. Some countries have mixed systems, where there is both a place of incorporation test and a place of effective management test.

With respect to taxation of outbound investments of resident companies, two broad models can be identified: the worldwide system and the territorial system. It should be noted that these categories are simplifications, as most countries in practice apply a combination of both systems.

A country employing a worldwide system subjects its residents to tax on their worldwide income whether derived from sources in or outside its territory. In order to implement the residence principle, the tax administration in the country of residence has to collect information with respect to the foreign-source income of their residents. As a result, countries rarely, if ever, adopt pure worldwide systems of taxation. Instead, under most of these systems foreign-sourced profits of foreign subsidiaries are taxed upon repatriation (the deferral system), and not on an accrual basis. In addition, the credit for tax paid on profits generated abroad is usually limited to the amount of taxation that would have been imposed on the foreign earnings by the residence country, thereby ensuring that the worldwide system does not impair the residence state’s taxation of its own domestic source income.

A country applying a territorial CIT system subjects its residents to tax only on the income derived from sources located in its territory. This means that resident companies are taxed only on their local income – i.e. income deemed to have their source inside the country. Determining the source of business income is therefore key in a territorial system.

Controlled foreign company (CFC) rules

CFC rules provide for the taxation of profits derived by non-resident companies in the hands of their resident shareholders. They can be thought of as a category of anti-avoidance rules, or an extension of the tax base, designed to tax shareholders on passive or highly mobile income derived by non-resident companies in circumstances where, in the absence of such rules, that income would otherwise have been exempt from taxation (e.g. under a territorial system) or only taxed on repatriation (e.g. under a worldwide tax system with a deferral regime).

CFC rules vary substantially in approach. In some instances, they seek to reduce tax incentives to undertake business or investment through a non-resident company. But they may also include provisions (such as the exclusion of active income) intended to ensure that certain types of investment in a foreign jurisdiction by residents of the country applying the CFC regime will be subject to no greater overall tax burden than investment in the same foreign jurisdiction by shareholders that are not residents. Most systems of CFC rules have the character of anti-avoidance rules targeting diverted income, and are not intended to deter genuine foreign investment.

CFC rules require some or all of the foreign company's profits to be included in the income of the resident shareholder, and thus may also have the effect of protecting the tax base of the source country by discouraging investments that erode its tax base or that are designed to shift profit to low-tax jurisdictions.

With respect to the taxation of inbound investments of non-resident companies, both a worldwide tax system and a territorial tax system impose tax on income arising from domestic sources. Hence, the determination of source of the income is key. Sourcing rules vary from country to country. With respect to business income, the concept of source under domestic law often parallels the concept of permanent establishment (PE) as defined under tax treaties. Such income is typically taxed on a net basis. For practical reasons however, it may be difficult for a country to tax certain items of income derived by non-resident corporations. It may also be difficult to know what expenses a non-resident incurred in earning such income. As a result, taxation at source of certain types of income (e.g. interest, royalties, dividends) derived by non-resident companies commonly occurs by means of withholding taxes at a gross rate. To allow for the fact that no deductions are allowed, gross-based withholding taxes are imposed at rates that are usually lower than standard corporate tax rates.

2.3.2 The taxation of cross-border income under double tax treaties

The exercise of tax sovereignty may entail conflicting claims from two or more jurisdictions over the same taxable amount, which may lead to juridical double taxation, which is the imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same income. Double taxation has harmful effects on the international exchange of goods and services and cross-border movements of capital, technology and persons. Bilateral tax treaties address instances of double taxation by allocating taxing rights to the contracting states. Most existing bilateral tax treaties are concluded on the basis of a model, such as the OECD Model Tax Convention or the United Nations Model, which are direct descendants of the first Model of bilateral tax treaty drafted in 1928 by the League of Nations. As a result, while there can be substantial variations between one tax treaty and another, double tax treaties generally follow a relatively uniform structure, which can be viewed as a list of provisions performing separate and distinct functions: *(i)* articles dealing with the scope and application of the tax treaty, *(ii)* articles addressing the conflict of taxing jurisdiction, *(iii)* articles providing for double taxation relief, *(iv)* articles concerned with the prevention of tax avoidance and fiscal evasion, and *(v)* articles addressing miscellaneous matters (e.g. administrative assistance).

2.3.2.1 A historical overview of the conceptual basis for allocating taxing rights

As global trade increased in the early 20th century, and concerns around instances of double taxation grew, the League of Nations appointed in the early 1920s four economists (Bruins et al., 1923) to study the issue of double taxation from a theoretical and scientific perspective. One of the tasks of the group was to determine whether it is possible to formulate general principles as the basis of an international tax framework capable of preventing double taxation, including in relation to business profits.[2] In this context the group identified the concept of economic allegiance as a basis to design such international tax framework. Economic allegiance is based on factors aimed at measuring the existence and extent of the economic relationships between a particular state and the income or person to be taxed. The four economists identified four factors comprising economic allegiance, namely *(i)* origin of wealth or income, *(ii) situs* of wealth or income, *(iii)* enforcement of the rights to wealth or income, and *(iv)* place of residence or domicile of the person entitled to dispose of the wealth or income.

Among those factors, the economists concluded that in general, the greatest weight should be given to "the origin of the wealth [i.e. source] and the residence or domicile of the owner who consumes the wealth". The origin of wealth was defined for these purposes as all stages involved in the creation of wealth: "the original physical appearance of the wealth, its subsequent physical adaptations, its transport, its direction and its sale". In other words, the group advocated that tax jurisdiction should generally be allocated between the state of source and the state of residence depending on the nature of the income in question. Under this approach, in simple situations where all (or a majority of) factors of economic allegiance coincide, jurisdiction to tax would go exclusively with the state where the relevant elements of economic allegiance have been characterised. In more complex situations in which conflicts between the relevant factors of economic allegiance arise, jurisdiction to tax would be shared between the different states on the basis of the relative economic ties the taxpayer and his income have with each of them.

On the basis of this premise, the group considered the proper place of taxation for the different types of wealth or income. Business profits were not treated separately, but considered under specific classes of undertakings covering activities nowadays generally categorised as "bricks and mortar" businesses, namely "Mines and Oil Wells", "Industrial Establishments" or "Factories", and "Commercial Establishments".[3] In respect of all those classes of activities, the group came to the conclusion that the place where income was produced is "of preponderant weight" and "in an ideal division a preponderant share should be assigned to the place of origin". In other words, in allocating jurisdiction to tax on business profits, greatest importance was attached to the nexus between business income and the various physical places contributing to the production of the income.

Many of the report's conclusions proved to be controversial and were not entirely followed in double tax treaties. In particular, the economists' preference for a general exemption in the source state for all "income going abroad" as a practical method of avoiding double taxation[4] was explicitly rejected by the League of Nations, who chose as the basic structure for its 1928 Model the "classification and assignment of sources" method – i.e. attach full or limited source taxation to certain classes of income and assign the right to tax other income exclusively to the state of residence. Nevertheless, the theoretical background enunciated in the 1923 Report has survived remarkably intact and is generally considered as the "intellectual base" (Ault, 1992: 567) from which the various League of Nations models (and consequently virtually all modern bilateral tax treaties) developed (Avi-Yonah, 1996).

Before endorsing the economic allegiance principle, the group of four economists briefly discussed other theories of taxation, including the benefit principle (called at the time the "exchange theory"), and observed that the answers formulated by this doctrine had to a large extent been supplanted by the theory of ability to pay. Several authors consider that the decline of the benefit theory is undeniable as far as determination of the amount of tax liability is concerned, but not in the debate on taxing jurisdiction in an international context (Vogel, 1988). Under the benefit theory, a jurisdiction's right to tax rests on the totality of benefits and state services provided to the taxpayer that interacts with a country (Pinto, 2006), and corporations, in their capacity as agents integrated into the economic life of a particular country, ought to contribute to that country's public expenditures. In other words, the benefit theory provides that a state has the right to tax resident and non-resident corporations who derive a benefit from the services it provides. These benefits can be specific or general in nature. The provision of education, police, fire and defence protection are among the more obvious examples. But the state can also provide conducive and operational legal structures for the proper functioning of business, for example in the form of a stable legal and regulatory environment, the protection of intellectual property and the knowledge-based capital of the firm, the enforcement of consumer protection laws, or well-developed transportation, telecommunication, utilities and other infrastructure (Pinto, 2006).

2.3.2.2 Allocation of taxing rights under tax treaties

At the time the four economists presented their report, various jurisdictions had already started addressing juridical double taxation through bilateral and unilateral measures. The League of Nations Tax Committees built upon the practical experience of government experts with negotiating and administering contemporary treaties. Partly as a result of historic path dependence, and partly due to the need for an effective way to allocate taxing rights between tax systems that may diverge significantly, avoidance of double taxation was not addressed by an alternative system such as formulary apportionment, or another system based on the principles identified by the four economists. Instead, supported by the development of the OECD and UN Model treaties, the international tax framework developed around a vast network of bilateral tax treaties following the so-called "classification and assignment of sources" method, in which different types of income are subject to different distributive rules. This schedular nature of distributive rules entails a preliminary step, whereby the income subject to conflicting claims is first classified into one of the categories of income defined by the treaty. Where an item of income falls under more than one category of income, double tax treaties resolve the conflict through ordering rules. Once the income is characterised for treaty purposes, the treaty provides distributive rules that generally either grant one contracting state the exclusive right to exercise domestic taxing rights or grant one contracting state priority to exercise its domestic taxing right while reserving a residual taxing right to the other contracting state.

Treaty rules provide that business profits derived by an enterprise are taxable exclusively by the state of residence unless the enterprise carries on business in the other state through a PE situated therein. In the latter situation, the source state may tax only the profits that are attributable to the PE. The PE concept is thus used to determine whether or not a contracting state is entitled to exercise its taxing rights with respect to the business profits of a non-resident taxpayer. Special rules apply, however, to profits falling into certain enumerated categories of income, such as dividends, interest, royalties, and capital gains.

The PE concept effectively acts as a threshold which, by measuring the level of economic presence of a foreign enterprise in a given State through objective criteria, determines the circumstances in which the foreign enterprise can be considered sufficiently integrated into the economy of a state to justify taxation in that state (Holmes, 2007; Rohatgi, 2005). A link can thus reasonably be made between the requirement of a sufficient level of economic presence under the existing PE threshold and the economic allegiance factors developed by the group of economists more than 80 years ago. This legacy is regularly emphasised in literature (Skaar, 1991), as well as reflected in the existing OECD Commentaries when it is stated that the PE threshold "has a long history and reflects the international consensus that, as a general rule, until an enterprise of one State has a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits".[5] By requiring a sufficient level of economic presence, this threshold is also intended to ensure that a source country imposing tax has enforcement jurisdiction, the administrative capability to enforce its substantive jurisdiction rights over the non-resident enterprise.

The PE definition initially comprised two distinct thresholds: *(i)* a fixed place through which the business of the enterprise is wholly or partly carried on or, where no place of business can be found, *(ii)* a person acting on behalf of the foreign enterprise and habitually exercising an authority to conclude contracts in the name of the foreign enterprise. In both situations a certain level of physical presence in the source jurisdiction is required, either directly or through the actions of a dependent agent. Some extensions have been made over time to address changes in business conditions. For example, the development of the service industry has led to the inclusion in many existing bilateral treaties of an additional threshold whereby the performance of services by employees (or other persons receiving instructions) of a non-resident enterprise may justify source-based taxation as soon as the duration of such services exceeds a specific period of time, irrespective of whether the services are performed through a fixed place of business (Alessi, Wijnen and de Goede, 2011).

Treaty rules on business profits provide that only the profits "attributable" to the PE are taxable in the jurisdiction where the PE is located. These are the profits that the PE would be expected to make if it were a distinct and separate enterprise.

By virtue of separate distributive rules which take priority over the PE rule, some specific items of income may be taxed in the source jurisdiction even though none of the alternative PE thresholds are met in that country. These include:

- Income derived from immovable property (and capital gains derived from the sale thereof), which generally may be taxed by the country of source where the immovable property is located.
- Business profits that include certain types of payments which, depending on the treaty, may include dividends, interest, royalties or technical fees, on which the treaty allows the country of source to levy a limited withholding tax.

In the case of outbound payments of dividends, interest, and royalties, countries commonly impose tax under their domestic law on a gross basis (i.e. not reduced by the deduction of expenses) by means of a withholding tax. Bilateral tax treaties commonly specify a maximum rate at which the source state may impose such a withholding tax, with the residual right to tax belonging to the state of residence.[6] However, where the asset giving rise to such types of income is effectively connected to a PE of the non-resident enterprise in the same state, the rules for attribution of profits to a PE control (Article 10(4), 11(4) and 12(3) of the OECD Model Tax Convention).

Where priority is given by bilateral tax treaties to the taxing rights of the source jurisdiction, the resident state must provide double taxation relief. Two mechanisms are generally available in bilateral tax treaties, namely the exemption method and the credit method. But in practice many jurisdictions, and accordingly existing bilateral tax treaties, use a mixture of these approaches – i.e. exemption method for income attributable to a PE, and credit method for items of income subject to a withholding – in relation to business profits (Rohatgi, 2005).

2.4 Value added taxes and other indirect consumption taxes

Value added taxes (VAT) and other consumption taxes are generally designed to be indirect taxes. While they are generally intended to tax the final consumption of goods and services, they are collected from the suppliers of these goods and services rather than directly from the consumers. The consumers bear the burden of these taxes, in principle, as part of the market price of the goods or services purchased.

Two categories of consumption taxes are generally distinguished (OECD, 2013):

- General taxes on goods and services, consisting of VAT and its equivalent in several jurisdictions, sales taxes and other general taxes on goods and services.
- Taxes on specific goods and services, consisting primarily of excise taxes, customs and import duties, and taxes on specific services (e.g. taxes on insurance premiums and financial services).

This section focuses mainly on VAT, which is the primary form of consumption tax for countries around the world. The combination of the global spread of VAT and the rapid globalisation of economic activity, which resulted in increased interaction between VAT systems, and increasing VAT rates (OECD, 2012) have raised the profile of VAT as a significant issue in cross-border trade.

2.4.1 Main design features of a VAT

2.4.1.1 Overarching purpose of a VAT – A broad-based tax on final consumption

The term VAT is used here to cover all value added taxes, by whatever name, in whatever language, they are known. Note, for instance, that many countries refer to their value added taxes as a "goods and services tax" (GST) (e.g. Australia, Canada, India, New Zealand and Singapore). While there is considerable diversity in the structure of the VAT systems currently in place, most of these systems are grounded on certain fundamental design principles that are described in this section, at least in theory if not in practice. The overarching purpose of a VAT is to impose a broad-based tax on consumption, which is understood to mean final consumption by households.

In principle only private individuals, as distinguished from businesses, engage in the consumption at which a VAT is targeted. In practice, however, many VAT systems impose VAT burden not only on final household consumption, but also on various entities that are involved in non-business activities or in VAT-exempt activities. In such situations, VAT can be viewed alternatively as treating such entities as if they were end consumers, or as "input taxing" the supplies made by such entities on the presumption that the burden of the VAT imposed will be passed on in the prices of the outputs of those non-business activities.

2.4.1.2 The central design feature of a VAT – Staged collection process

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 (taxable person) in the supply chain is responsible for collecting the tax on its outputs (supplies) and remitting the proportion of tax corresponding to its margin, i.e. the value added, in a particular tax period. This means that the taxable person remits the difference between the VAT imposed on its taxed outputs (output tax) and the VAT imposed on its taxed inputs (input tax) for this period. Thus, the tax is in principle collected on the "value added" at each stage of production and distribution. In this respect, the VAT differs from a retail sales tax, which taxes consumption through a single-stage levy imposed in theory only at the point of final sale.

This central design feature of the VAT, coupled with the fundamental principle that the burden of the tax should not rest on businesses, requires a mechanism for relieving businesses of the burden of the VAT they pay when they acquire goods or services. There are two principal approaches to implementing the staged collection process while relieving businesses of the VAT burden. Under the invoice-credit method, each taxable person charges VAT at the rate specified for each supply and passes to the customer an invoice showing the amount of tax charged. If the customer is also a taxable person, it will be able to credit that input tax against the output tax charged on its sales, each being identified at the transaction level, remitting the balance to the tax authorities or receiving a refund of any excess credits. Under the subtraction method, the tax is levied directly on an accounts-based measure of value added, which is determined for each business by subtracting the taxable person's allowable expenditure on inputs for the tax period from taxable outputs for that period and applying the tax rate to the resulting amount (Cockfield et al., 2013). Almost all jurisdictions that operate a VAT use the invoice-credit method, the Japanese system being the most notable example of a subtraction method consumption tax.

VAT exemptions create an important exception to the neutrality of VAT. When a supply is VAT-exempt, this means that no output tax is charged on the supply and that the supplier is not entitled to credit the related input tax. Many VAT systems apply exemptions for activities that are hard to tax (the exemption for financial services being the most notable example) and/or to pursue distributional objectives (agricultural and fuel exemptions and exemptions for basic health and education are commonly encountered). One adverse consequence of VAT exemptions is that they create "cascading" when applied in a business-to-business (B2B) context. The business making an exempt supply can be expected to pass on the uncreditable input tax in the price of this supply, while this "hidden tax" can subsequently not be credited by the recipient business.

2.4.2 VAT on cross-border transaction – The destination principle

The fundamental policy issue in relation to the international application of the VAT is whether the levy should be imposed by the jurisdiction of origin or by the jurisdiction of 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.

Under the destination principle, no VAT is levied on exports and the associated input tax is refunded to the exporting business (this is often called "free of VAT" or "zero-rated"), while imports are taxed on the same basis and at the same rates as domestic supplies. Accordingly, the total tax paid in relation to the supply is determined by the rules applicable in the jurisdiction of its consumption and all revenue accrues to the jurisdiction where the supply to the final consumer occurs. The application of the destination principle in VAT thus achieves neutrality in international trade, as there is no advantage in buying from a low or no-tax jurisdiction, nor do high and/or multiple VAT rates distort the level or composition of a country's exports.

By contrast, under the origin principle each jurisdiction would levy VAT on the value created within its own borders. 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. This approach runs counter to the core features of a tax on consumption, in which 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. By imposing tax at the various rates applicable in the jurisdictions where value is added, the origin principle could influence the economic or geographical structure of the value chain and undermine neutrality in international trade.

For these reasons, there is widespread consensus that the destination principle, with revenue accruing to the country 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 Organisation (WTO) rules. Footnote 1 of the WTO's *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."

2.4.3 Implementing the destination principle

While the destination principle has been widely accepted as the basis for applying VAT to international trade, its implementation is nevertheless diverse across jurisdictions. This can lead to double taxation or unintended non-taxation and to complexity and uncertainty for businesses and tax administrations. In order to apply the destination principle, VAT systems must have a mechanism for identifying the destination of supplies. Because VAT is generally applied on a transaction-by-transaction basis, VAT systems contain "place of taxation" rules that address all transactions, building on "proxies" that indicate where the good or service supplied is expected to be used by a business in the production and distribution process (if the supply is made to a business) or consumed (if the supply is made to a final consumer).

The following paragraphs provide a concise overview of the mechanisms for identifying the destination of a supply, first looking at supplies of goods and subsequently at supplies of services.

2.4.3.1 Implementing the destination principle – Goods

The term "goods" generally means "tangible property" for VAT purposes. The VAT treatment of supplies of goods normally depends on the location of the goods at the time of the transaction and/or their location as a result of the transaction. The supply of a good is in principle subject to VAT in the jurisdiction where the good is located at the time of the transaction. When a transaction involves goods being moved from one jurisdiction to another, the exported goods are generally free of VAT in the seller's jurisdiction (and are freed of any input VAT via successive businesses' deductions of input tax), whilst the imports are subject to the same VAT as equivalent domestic goods in the purchaser's jurisdiction. The VAT on imports is generally collected from the importer at the same time as customs duties, before the goods are released from customs control, although in some jurisdictions 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.

Many VAT systems apply an exemption for the importation of relatively low value goods. These exemptions are generally motivated by the consideration that the administrative costs of bringing these low value items into the customs system are likely to outweigh the revenue gained. If these additional costs would be passed on to consumers, the charges could be disproportionally high compared to the value of the goods. Most OECD countries apply such a VAT relief arrangement, with thresholds varying widely across countries.

2.4.3.2 Implementing the destination principle – Services

The VAT legislation in many countries tends to define a "service" negatively as "anything that is not otherwise defined", or to define a "supply of services" as anything other than a "supply of goods". While this generally also includes a reference to intangibles, some jurisdictions regard intangibles as a separate category. For the purposes of this section references to "services" include "intangibles" unless otherwise stated.[7]

A wide range of proxies can be used by VAT systems to identify the place of taxation of services, including the place of performance of the service, the place of establishment or actual location of the supplier, the residence or the actual location of the consumer, and the location of tangible property (for services connected with tangible property, such as repair services). Many systems use multiple proxies before the place of taxation is finally determined and may use different rules for inbound, outbound, wholly foreign, and wholly domestic supplies (Cockfield et al., 2013).

The application of these principles for identifying the place of taxation has become increasingly difficult as volumes of cross-border services are growing. VAT systems have considerable difficulties to determine where services are deemed to be consumed, to monitor this and to ensure collection of the tax, particularly where businesses sell services in jurisdictions where they do not have a physical presence. In practice, broadly two approaches can be distinguished for applying VAT to cross-border supplies of services (Ebrill et al., 2001):

- The first approach focuses on the jurisdiction where the customer is resident (established, located). Under this approach, when the customer is resident in another jurisdiction than the supplier, the supply is free of VAT ("zero-rated") in the jurisdiction of the supplier and is subject to VAT in the jurisdiction of the customer. In principle, the supplier needs to register in the customer's jurisdiction and collect and remit the tax there. In practice, when the customer is a VAT-registered business, the VAT is often collected through a "reverse charge" mechanism. This is a tax mechanism that switches the liability to pay the tax from the supplier to the customer. The business customer will generally be able to credit the input tax on the acquired service immediately against the output tax liability. Some VAT systems therefore do not require the reverse charge to be made if the customer is entitled to a full input tax credit in respect of the purchase.

- Under the second approach, the supply of the service is subjected to VAT in the jurisdiction where the supplier is resident (established, located). Supplies of services are then subject to VAT in the supplier's jurisdiction, even when they are performed abroad or supplied to foreign customers. Customers that are taxable businesses are generally able to apply for a refund of the VAT paid on business inputs in the supplier's jurisdiction, from the tax authorities of that jurisdiction.

For B2B supplies, both approaches have ultimately the same effect, in that "exported" services are relieved from any VAT burden in the origin country and subject to VAT in the jurisdiction where the service is deemed to be used by the business customer. The first approach, which identifies the place of taxation by reference to the location of the customer, is recommended as the main rule for applying VAT to B2B supplies of services by the OECD's *International VAT/GST Guidelines* (OECD, 2014). It was also the recommended approach for "cross-border supplies of services and intangibles that are capable of delivery from a remote location" under the OECD's 2003 E-commerce Guidelines (OECD, 2003a). A key advantage of this approach is that it avoids the need for cross-border refunds of VAT to businesses that have acquired services abroad, which often involve considerable administrative and compliance burden and costs for tax administrations and businesses. In practice, however, many VAT systems apply the second approach, taxing services by reference to the location of the supplier, mainly to minimise the risk of fraud through claims of exported services which are typically difficult to verify.

Whereas both approaches lead to a result that is consistent with the destination principle in a B2B context, the situation is more complicated for business-to-consumer (B2C) supplies. Implementing the destination principle by zero-rating cross-border supplies to non-resident final consumers and relying on self-assessment by the consumer in its jurisdiction of residence, is likely to result in widespread non-taxation of these supplies in practice. While reverse charge methods operate relatively well in a B2B context, they are generally viewed as ineffectual for B2C supplies. Such a method would require final consumers to self-assess their VAT liability on services purchased abroad, e.g. through their income tax returns. The level of voluntary compliance can be expected to be low, as private consumers have no incentive to voluntarily declare and pay the tax due, unlike taxable persons who can credit input tax paid against output tax (Lamensch, 2012). Collecting and enforcing this VAT, which may be small amounts in many cases, from large numbers of people is likely to involve considerable complexity and costs for tax payers and tax authorities.

Most VAT systems therefore tax supplies of services to private consumers in the jurisdiction where the supplier is resident (established, located). Many jurisdictions that zero-rate cross-border supplies of services to non-resident customers, limit the application of this regime to B2B supplies, notably by applying it only to services that are typically supplied to businesses (advertising, consultancy, etc.) Supplies to foreign private consumers are then subject to VAT in the supplier's jurisdiction while services acquired from abroad by resident final consumers are not subject to VAT in the consumer's jurisdiction. While this approach, which effectively results in origin taxation, is likely to be less vulnerable to fraud, it may create an incentive for suppliers to divert their activities to jurisdictions where no or a low VAT is applied and to sell remote services into foreign markets VAT-free or at a low VAT rate. This potential distortion and the associated revenue losses become increasingly significant as volumes of cross-border supplies of services keep growing.

More and more jurisdictions therefore consider ways to implement a destination based approach for both B2B and B2C cross-border supplies of services, thereby relying on a system that would require suppliers to collect and remit the tax in line with what was recommended by the OECD's E-commerce Guidelines (OECD, 2003a). As self-assessment methods are unlikely to offer an effective solution for collecting the tax at destination in a B2C-context, a system that requires suppliers to collect and remit the tax may appear the only realistic alternative. This was notably the conclusion of the OECD's Consumption Tax Guidance Series, which provided guidance for the implementation of the E-commerce Guidelines (OECD, 2003b-c-d). This guidance indicated that countries may consider it necessary for non-resident vendors to register and account for the tax in the jurisdiction of consumption, and it recommended the use of simplified registration regimes and registration thresholds to minimise the potential compliance burden. The most notable application of a destination-based approach for taxing B2C cross-border supplies of services relying on a simplified registration system for non-resident suppliers, is the European Union's "One Stop Shop" scheme.

Notes

1. This global approach is generally co-ordinated with specific tax regimes applying to items of income derived from specific types of assets (e.g. participation shares, patents and trademarks).

2. Noteworthy, at the time the study was performed most of the industrialised countries had not yet introduced in their domestic legislation a modern corporate income tax system integrated with personal income taxes.

3. Professional earnings were considered separately, unless the concerned activity gives rise to a branch in another country, in which case the occupation becomes a commercial enterprise and, according to the economist, ought to fall under the same allocation rule as other businesses.

4. The predominant argument put forward by the economists to reach a conclusion (i.e. exclusive taxation in the state of residence) was convenience and practicability.

5. OECD Commentaries on Art. 7, par. 11; see also in relation to service activities, Commentaries on Art.5, par. 42.11.

6. These limitations on withholding at source generally do not apply, however, to excessive payments of interest or royalties to related parties. For instance, paragraph 6 of Article 11 of the OECD Model Convention provides that, if there is a special relationship between the payer and the recipient as a result of which the interest is higher than that which they would have agreed upon in the absence of such a relationship, the excess part remains taxable according to the laws of both the source state and the residence state. Similar rules apply with respect to excessive royalties under paragraph 4 of Article 12 of the OECD Model Tax Convention.

7. Many VAT systems define a "service" negatively as "anything that is not otherwise defined", or a "supply of services" as anything other than a "supply of goods". While this generally also includes a reference to intangibles, some jurisdictions regard intangibles as a separate category, and this is explicitly recognised in this report where relevant. It should be noted that the term 'intangibles' when used for transfer pricing and direct tax purposes has a different meaning than that used under certain VAT legislations.

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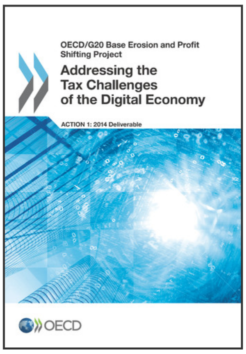

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