



Don't underestimate BEPS' impact on indirect tax

KPMG International

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Introduction

International tax issues have never been higher on the political agenda than they are today. In an increasingly interconnected world, national tax laws have not kept up with globalizing businesses, accelerating capital mobility and the rise of the digital economy. Tax policymakers believe that this has left gaps and mismatches in international tax laws that can be exploited to generate double non-taxation.

In this context, the Organisation for Economic Co-operation and Development (OECD) and G20 countries have worked closely to combat base erosion and profit shifting (BEPS). The project has entailed forging consensus on 15 Actions that combine to create a broad package of tax measures designed for coordinated implementation by participating countries domestically and through treaty provisions, supported by targeted monitoring and strengthened transparency. The goal is to tackle BEPS structures by addressing their root causes, not just the symptoms.

During their 15–16 November 2015 Summit, the G20 leaders endorsed the OECD's final BEPS recommendations on tax policies and treaties. The G20 leaders also endorsed the OECD International VAT/GST Guidelines ('the Guidelines') that representatives of more than 100 countries had endorsed on 6 November 2015.

Although the BEPS project is aimed primarily at corporate income tax, the indirect tax implications should certainly not be overlooked. Action 1 on the digital economy specifically addresses value added taxes and goods and services taxes (collectively, 'VAT'). While other Actions do not address VAT explicitly, they could have direct or indirect VAT impacts.

Further, given the general global shift in attitudes toward tax morality, current discussions with tax authorities on VAT are often influenced by their beliefs on how tax rules should apply, rather than the law as it stands.

In this article, we explore the impact that BEPS could have in the world of VAT, starting with the BEPS Action that directly addresses VAT (Action 1) and then considering Actions that likely will or might have VAT implications.

BEPS Action that directly addresses VAT

Action 1

Addressing the tax challenges of the digital economy

Action 1 is the only BEPS Action that discusses VAT directly. Action 1 aims to identify and address the challenges that the digital economy poses for existing international tax rules. The OECD report on Action 1 generally re-emphasizes that VAT should be imposed in the jurisdiction of destination (i.e., where final consumption occurs), in line with the Guidelines.

For business-to-business (B2B) transactions, the report reiterates the Guidelines' principles that the business customer should self-assess VAT under a reverse charge mechanism. However, where the business recipient performs VAT-exempt activities (e.g. financial services), there may be BEPS concerns if the recipient country does not require VAT self-assessment and/or the services received are taxable in the seller's country.

Additional BEPS concerns arise where a multi-location enterprise acquires a digital supply for use in multiple locations worldwide but VAT only applies in the country where the entity purchasing the supply is established. Because VAT generally does not apply to transactions between establishments of the same legal entity, the other establishments could purchase the services VAT-free. The Guidelines provide several options for countries to ensure taxation in the country of consumption. Depending on the option chosen, however, multiple or non-taxation could result.

Low-value imported goods

The Action 1 report addresses issues regarding low-value imports of goods and assesses a range of possible approaches countries may consider for increasing the efficiency of collecting VAT on such imports. Where goods are sold remotely from one jurisdiction to another, VAT is generally payable when they are imported into the customer's jurisdiction by the importer of record. For the tax authority, it is easier to collect the tax from the business recipient than the remote seller in B2B transactions. In business-to-consumer (B2C) sales, this is not the case. To limit the administrative costs of levying VAT on imports, many jurisdictions exempt imported goods with 'low value' from VAT.

In e-commerce transactions, low-value exemptions can create incentives for in-country customers to purchase goods online from out-of-country sellers, giving the foreign sellers a competitive advantage. The harmonized single market of the European Union (EU) has no low-value threshold, but the remote seller is required to register for and collect VAT in the jurisdiction in which the consumer is located if a certain threshold of annual sales is reached ('distance selling regime'). While the BEPS discussions are ongoing, some jurisdictions, such as South

Africa, are considering modifying their VAT rules for these remote sales, by either changing the threshold value or putting into place distance selling rules (similar to those applying in the EU). In its VAT Action plan, released on 7 April 2016, the European Commission (EC) outlined it will propose legislation to extend the one-stop-shop mechanism for electronic services to B2C sales of goods within the EU and to remove the VAT exemption for the importation of small consignments from suppliers non-EU countries.

As the Action 1 discussion papers point out, however, in the experience of Australia and New Zealand, applying VAT to low-value imports creates new issues related to, for example:

- simplified or standard registration of remote sellers
- setting a registration threshold equal to or lower than resident sellers
- establishing a reliable enforcement mechanism for imports by land, air, and sea.

Again, differences in how individual jurisdictions implement the Action 1 recommendations will undoubtedly increase the compliance burden for taxpayers.

Sales of e-services to consumers

A larger part of the Action 1 report is dedicated to B2C sales of electronic services. The report reiterates the principle in the Guidelines that sales of electronic services in B2C transactions should be taxable in the country of destination and the remote seller should collect and remit VAT (the destination principle). Where countries have not implemented the destination principle the digital economy changes are unlikely to work as effectively since double taxation may result. For example, Indonesia does not zero rate or exempt most exported services. It will also be problematic in countries that impose currency controls, such as China, India and Thailand. In addition, an increasing number of countries, such as the UK, are imposing VAT compliance and collection obligations for online sales on the platform providers, such as Amazon, rather than the seller.

The Action 1 report also calls for simplified registration regimes to minimize compliance burdens, while suggesting that countries may limit VAT refunds under these simplified regimes. Unlike in the EU, with its one-stop shop for VAT, companies operating in Asia Pacific and Latin America need to follow separate and different registration requirements for every country where

consumers enjoy their services. This leads to less manageable compliance costs. Simplified registration regimes could help reduce this compliance burden.

Since the BEPS discussions began, many countries have shown interest in these new rules:

- In 2015, the EU updated its VAT place of supply rules for B2C sales of telecommunications, broadcasting and electronically supplied services, requiring remote sellers to collect and remit VAT in the country where the consumer is established, regardless of the seller's location.
- Albania, Bahamas, Ghana, Japan, Kenya, South Africa, South Korea and Tanzania have also introduced special rules for B2C (and sometimes B2B) sales of electronic services.
- Australia has amended its Goods and Services Tax (GST) legislation in this respect, and New Zealand is considering similar changes.

The rules of all these jurisdictions follow the OECD's general principles, but differing registration thresholds, application to B2B and/or B2C, definitions of electronic services and other inconsistencies are compounding compliance challenges for digital businesses across the globe.

Digital business models disrupted

The report also addresses a range of other VAT issues related to the digital economy, including:

- VAT treatment of virtual currencies
- customs qualification of 3D printing
- VAT treatment of the sharing economy
- treatment of mixed supplies (e.g. virtual healthcare, e-books, software provided in combination with hardware that may be subject to various rates).

As more countries follow up on the Action 1 recommendations, digital economy businesses should review their existing operating and pricing models and prepare for the potential need to redesign their business set-up and infrastructure entirely. To adapt successfully to the new BEPS reality, timely assessment of potential VAT consequences and careful consideration of alternative business models will be critical.

Actions that do not address VAT but will directly affect VAT

There are four OECD BEPS Actions that do not specifically address VAT, but which likely will directly affect the VAT positions of multinational enterprises.

Action 7

Preventing the artificial avoidance of permanent establishment status

Action 7 aims to prevent the artificial avoidance of permanent establishment status for corporate income tax purposes by redefining the threshold for creating a permanent establishment, especially for commissionaire structures. Among other things, the Action 7 recommendations:

- address the exception for preparatory and auxiliary activities
- call for new anti-fragmentation rules
- propose new rules on splitting contracts for construction activities.

In addition, the challenges of establishing nexus in the context of the digital economy are explored in the report on Action 1.

Impact on VAT registration requirements

Any redefinition of 'permanent establishment' for corporate income tax purposes could affect VAT registration requirements. Many jurisdictions, especially in Latin America, link the VAT registration obligations for non-residents to the existence of such a permanent establishment. Lowering the permanent establishment threshold as Action 7 suggests would create VAT registration requirements for more non-residents. Countries will also need to clarify the VAT consequences of having a permanent establishment for corporate income tax purposes. In particular, they would need to consider possible differences in the treatment of non-resident businesses depending on whether or not they are resident in a tax treaty country.

Impact on the EU's 'fixed establishment' concept

The Action 7 recommendation may affect the concept of 'fixed establishment' used in the EU for VAT purposes. Currently, fixed establishment and permanent establishment are defined differently, and it is possible to have a permanent establishment for direct tax purposes without having a fixed establishment for VAT purposes. However, some jurisdictions, such as France and Spain, do not seem to accept the absence of a fixed establishment where a permanent establishment exists, which already causes confusion. Since 'fixed establishment' is an EU-specific concept, the BEPS initiative does not address it. As a result, any changes to the permanent establishment definition under BEPS may widen

the gap in the EU between the definitions used for direct tax and VAT purposes.

Businesses will need to review their supply chains in light of these new challenges. This is even more important given recent case law. Based on European Court of Justice rulings, a fixed establishment does not need to have its own staff and technical resources if external resources are available to the establishment in the same way as they would if the establishment employed them directly.

For greater legal certainty and ease of compliance, many international companies would like to see more alignment between the permanent and fixed establishment definitions. The BEPS project could well steer discussions in that direction.

Actions 8–10

Aligning transfer pricing outcomes with value creation

Actions 8, 9, and 10 cover transfer pricing concepts, including rules to prevent base erosion and profit shifting by:

- moving intangibles among group members
- transferring risks among, or allocating capital to, group members
- engaging in transactions that would not, or only rarely, be undertaken between third parties.

While these Actions deal with transfer pricing issues exclusively, most transfer pricing decisions have implications for indirect taxes and customs duties.

First, some jurisdictions require the consideration paid in related-party transactions to be based on the arm's length standard, and their rules refer to transfer pricing definitions directly (e.g. Australia, Singapore, New Zealand). Second, a transfer pricing adjustment may cause an adjustment to the (factual and commercial) consideration paid in that transaction.

However, countries treat transfer pricing adjustments in different ways. Some consider transfer pricing adjustments as VAT-relevant adjustments to the prices agreed between the

Impact on commissionaire structures

The VAT treatment of supply chains using a commissionaire structure may also change as a result of Action 7. For EU VAT purposes, commissionaire arrangements are considered as buy/sell arrangements. In Australia, Canada, New Zealand and some other countries, a commissionaire making sales on a principal's behalf is generally not considered as a seller for VAT purposes. Thus, if commissionaires constitute permanent establishments for corporate income tax purposes due to Action 7, any special VAT rules for commissionaires may need to be amended accordingly.

It is regrettable that the VAT consequences were not considered in developing the Action 7 recommendations. In our view, direct and indirect tax treatment should be streamlined to reduce administrative and compliance complications for tax authorities and taxpayers alike, especially since indirect taxes are not always given priority by tax directors, despite the steep costs that arise when they are improperly managed.

parties. Others may disregard transfer pricing adjustments if only the corporate tax returns were amended (not the commercial pricing) and no actual payment was made. VAT adjustments may have a number of consequences:

- Taxpayers' compliance burden would increase as they would need to disclose the amendment either on an amended VAT return for the period of the original payment or in the period of the adjustment.
- The parties would need to consider whether to create a new invoice to reflect the adjustment, or whether a credit/debit note would suffice.
- Correlative transfer pricing adjustments to, for example, interest, dividends and services may create additional VAT issues.

Finally, changes relating to intellectual property valuation could affect custom valuations and thus any import VAT paid. For example, under the Union Customs Code, which took effect in the EU on 1 May 2016, certain intangibles are included in the customs valuation, increasing not only any potential customs duty but also the import VAT due.

Actions that may have indirect VAT effects

The OECD BEPS Actions discussed in this section do not specifically address VAT, but they might affect the VAT positions of multinational enterprises indirectly.

Action 2

Neutralizing the effects of hybrid mismatch arrangements

Action 2 aims to develop model treaty provisions and recommendations for the design of domestic rules to neutralize the effects of hybrid mismatch arrangements. These arrangements exploit differences in the tax treatment of entities or instruments under the laws of two or more jurisdictions.

While Action 2 does not have a clear impact on VAT, it could be used to define what types of financial services should be exempt or taxable. Further, if the characterization of hybrid instruments is clarified for corporate income tax purposes, tax authorities may want to mirror the treatment for VAT purposes. For example, if a certain type of instrument is considered as interest for corporate income tax purposes, tax authorities may seek to treat it as such for indirect tax purposes which in turn may negatively affect the VAT recovery ratio of the entity using the hybrid instrument.

Action 5

Countering harmful tax practices more effectively, taking into account transparency and substance

Action 5 aims to:

- identify preferential tax regimes
- introduce compulsory spontaneous exchange on rulings related to preferential tax regimes
- require substantial activity for any preferential regime including intangible property regimes.

In view of Action 5 and the work done by the OECD Forum on Harmful Tax Practices, many companies will likely amend their intangible property structures, thereby creating VAT implications. Spontaneous exchanges of rulings related to preferential regimes may give tax authorities more information about the application of VAT on intra-company transactions. Further, countries that provide preferential VAT treatment to certain taxpayers (e.g. special rates, exemptions, relief for certain taxpayers) could extend the spontaneous exchange of rulings for direct taxes to also cover indirect taxes.

Action 12

Mandatory disclosure rules

Action 12 aims to require taxpayers to disclose their aggressive tax planning arrangements. Specifically, the Action 12 proposals call for mandatory disclosure of aggressive or abusive transactions, arrangements and structures, taking into account the administrative costs for tax administrations and businesses and drawing on the experiences of the increasing number of countries that already impose such rules.

Where transactions are disclosed for direct tax purposes, their indirect tax aspects would need to be considered also. Further, some jurisdictions may be tempted to extend mandatory disclosure to indirect taxes in cases where taxpayers exploit differences between VAT regimes to their advantage (e.g. use of divergent place of supply rules resulting in non-taxation).

Action 13

Guidance on transfer pricing documentation and country-by-country reporting

Action 13 aims at developing rules for transfer pricing documentation to enhance transparency for tax administrations. Among other things, these rules will require international companies to use a common template to provide tax authorities with details about their global allocation of income, economic activity and taxes paid among countries.

While Action 13 focuses on direct taxes, tax authorities may use the information disclosed for indirect tax purposes in order to better understand a multinational enterprise's operations and identify transactions that should be taxable for VAT and customs duty purposes. Countries also may be tempted to extend the OECD's proposal for country-by-country reporting to VAT as well as corporate income tax.

Action 15

Developing a multilateral instrument to modify bilateral tax treaties

The purpose of Action 15 is to streamline the implementation of tax treaty-related BEPS measures through a multilateral instrument to amend all existing bilateral tax treaties at once. To date, 90 countries are taking part in developing the multilateral instrument.

While the focus is again on direct taxes, such a multilateral instrument may have consequences for VAT purposes, for example, if it provides for mandatory information sharing between tax authorities or addresses abusive tax structures.

In fact, the EC recently began negotiations with Norway to establish a framework of mutual assistance to address

cross-border VAT fraud and help countries recover the appropriate amount of VAT. Some of these cooperative measures could be extended under any new agreements with non-EU member states. These measures include access to databases, exchange of information and participation in networks for sharing intelligence on VAT fraud. The EC is considering entering into similar discussions with other major trade partners such as Canada, China, Russia, Turkey and the United States.

Conclusion

Although the OECD BEPS Action Plan primarily focuses on direct taxes, taxpayers should not underestimate its importance for indirect taxes. VAT implications could arise not only as a result of Action 1, which addresses VAT specifically, but also in the other areas discussed above, such as the impact of changing permanent establishment rules, their interaction with the EU fixed establishment concept, and increased interaction between transfer pricing, global trade

and VAT. It is likely that the BEPS initiatives will lead to many organizations restructuring and this in itself will give rise to VAT and other transaction tax issues, for example those involving transfers of going concerns.

Accordingly, multinational enterprises are advised to monitor and consider the impact of BEPS on their VAT positions and include indirect taxes in their BEPS analyses and planning for business transformation.

Related publications

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Asia Pacific is a dynamic and diverse region of increasing importance to world trade. That diversity is reflected in the indirect tax regimes and their local application across the region. The 2016 Asia Pacific Indirect Tax Country Guide includes a summary of the indirect tax regimes and compliance administrative issues of 20 countries in the Asia Pacific region.

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2016 Africa indirect tax country guide

With some of the world's fastest growing economies, Africa is a key strategic growth imperative for most global corporates, and African governments are placing high reliance on indirect taxes to meet growing revenue needs. The 2016 Africa Indirect Tax Country Guide includes a summary of the indirect tax regimes and compliance administrative issues of 23 countries in the region.

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