

Value Added Tax and Direct Taxation

Similarities and Differences

Sample excerpt

TAX TREATIES — A SOLUTION TO VAT/GST DOUBLE TAXATION

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I. The problem of double taxation in VAT/GST

Consumption taxes, such as value added taxes (VAT), goods and services taxes (GST), or retail sales taxes, have been around for about 60 years and, thus, are fairly young compared to direct taxes. Nevertheless, VAT has been spreading with enormous speed and as of early 2006, there were around 140 countries with a VAT of some sort.² Over 100 of those countries have introduced VAT within the last 20 years.³ In the future, the number of countries relying on VAT is expected to increase further.

Simultaneously, globalization and rapid improvements in technology have led to a drastic increase in global trade and international cross-border activities. The two developments — the spread of VAT and the increase in cross-border economic activities — have together led to a new situation where global actors regularly have to deal with two or more different VAT jurisdictions when carrying on international business. In some of these cases, as a consequence of the absence of internationally agreed principles, more than one country may want to levy tax on a cross-border transaction. The result is double or multiple taxation (or in the inverse case: double or multiple non-taxation).⁴ The harmful effects of double taxation (such as distortion of competition) on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacle that double taxation presents to the development of economic relations between countries.⁵

The most common reasons for double taxation are:⁶

- the use of different rules to determine the place of taxation;

¹ The author would like to thank Prof. Rick Krever and Prof. Michael Lang for the discussion and helpful comments on this paper.

² See Bird/Gendron, *The VAT in Developing and Transitional Countries* (2007) p. 16; see also OECD, *Consumption Tax Trends 2008* (2008), p. 32.

³ International Tax Dialogue, *The Value Added Tax: Experiences and Issues*, prepared for the ITD Conference on the VAT, Rome March 15–16, 2005, p. 9.

⁴ For some examples see Millar, "Cross-Border Services: A Survey of the Issues", *New Zealand Journal of Taxation Law and Policy* 2007, pp. 302 et seq.; OECD, *Report – The application of consumption taxes to the trade in international services and intangibles*, 2004, pp. 8 et seq.; see generally also Ruppe, General Report, *Cahiers de Droit Fiscal International, Volume LXVIIIb* (1983) p. 109 (pp. 121 et seq.).

⁵ See para. 1 of the introduction to the OECD Model.

⁶ See OECD, *The Application of Consumption Taxes to the International Trade in Services and Intangibles – Progress Report and Draft Principles*, 2005, p. 3; Erikson, "Should Tax Treaties Play a Role for Consumption Taxes?", *Intertax* 2005, p. 166 (p. 168); Millar, "GST issues for international services transactions", *Australian GST Journal* 2004, p. 285 (pp. 288 et seq.).

- different interpretation of (otherwise similar) place of taxation rules, the order of these rules, or a different interpretation of the surrounding key proxies and concepts for determining the place of taxation;
- different characterization of a transaction (even if similar rules are in place to determine the place of taxation);
- non-recoverability of tax; and
- input taxation without the right to deduction in one country (e.g. because the taxpayer's supplies are exempt in that country) while the same supply is subject to VAT/GST in another country.

This paper will only deal with the first three of the above-mentioned reasons for double taxation. It aims especially at providing a contribution to solve double taxation caused by different place of taxation rules. The non-recoverability of tax⁷ and the problem of input taxed supplies that are taxable in another country are not a subject of the paper.⁸

As VAT is harmonized within the European Community (EC), it is not surprising that the risk of double taxation is not as common between the Member States of the European Union (EU) as it may be between EU Member States and third countries. And if, despite the harmonized rules, VAT double taxation occurs within the European Common Market, it is usually the responsibility of the European Court of Justice (ECJ) to solve this issue.⁹ Therefore, this contribution will not cover mere EU cases. It will only address the question of double taxation between an EU Member State and a non-EU Member State as well as between two non-EU Member States.¹⁰

II. A proposed solution – VAT/GST treaties

There are multiple ways to address the issue of double taxation in VAT/GST. One way to resolve double taxation problems is unilateral measures that by themselves avoid double taxation. One country voluntarily (i.e. without being obliged e.g. by means of a bi- or multilateral agreement) introduces a regulation into its domestic law to relieve a taxpayer if he is also taxed in another country. This domestic measure generally provides for an exemption of domestic tax or for a credit of foreign tax on the domestic tax liability. In practice, however, these unilateral measures for different reasons only rarely provide relief. In many countries, regulations that unilaterally avoid double taxation are not applicable to VAT or GST. Where consumption taxes fall under the scope of such a provision, it is often applied only in the case of reciprocity, i.e. the other country taxing the transaction has a similar provision in its domestic law. Furthermore, it is possible that countries that have unilateral domestic

⁷ The extensive use of the destination principle and the direct applicability of the treaty benefits should, however, be able to abate this problem.

⁸ Although, admittedly, tax treaties could also be used to foster recoverability of tax, e.g. through the inclusion of a reciprocity clause for refunds.

⁹ See e.g. European Commission, Consultation paper – Introduction of a mechanism for eliminating double imposition of VAT in individual cases, 5 January 2007, TAXUD/D1/..., p. 3; a different interpretation of facts may, however, still lead to double taxation. For this reason the Commission proposes the introduction of a mutual agreement and arbitration procedure in these cases (see same document).

¹⁰ The question as to who has the power to conclude treaties in an EU context is not treated in this paper. Further research is needed to assess whether the EU Member States still have the power to negotiate and conclude VAT/GST treaties. As VAT is harmonized within the European Union, it may be that this power now lies with the European Commission. It further has to be analysed whether the EU Member States even have the power to discuss and agree on a VAT/GST model convention, for example, in an OECD context.

provisions to avoid double taxation, only apply them if the person liable for VAT/GST is a resident of that country.¹¹ Additionally, these provisions often do not provide the taxpayer with an enforceable right but rather grant the tax administration a discretionary power to apply them. The consequence is legal uncertainty.

Another means to avoid VAT/GST double taxation is through coordination of national tax laws. The idea behind this concept is to promote assimilation of the different national taxing regimes, for instance through the development of international consumption tax principles. This is the path currently followed by the OECD. Since the late 1990s, the OECD's Committee on Fiscal Affairs (CFA) has been aware of the obstacles to economic activity of businesses that are created by today's international consumption taxes environment. As a consequence, the CFA assigned Working Party No. 9 (WP9) with the development of international VAT/GST principles that should serve national legislators as basis for the design of their country's VAT/GST and thus, should lead to an assimilation of the different legal consumption tax systems worldwide. In February 2006, the OECD published the first part of the *International VAT/GST Guidelines*.¹² Since that time, WP9 and its Technical Advisory Groups have been working to further develop and complete these guidelines, a task that is expected to take another couple of years.

A third and very innovative measure to avoid consumption tax double taxation would be the development of separate bi- or multilateral VAT/GST treaties. This approach is supported from many sides including scholars, business representatives, or officials of international organizations.¹³ With respect to income taxes, tax treaties have established themselves as the most used and accepted measure to tackle double taxation. Nowadays over 3,000 tax treaties are in place between countries worldwide.

The presented instruments to address the issue of VAT/GST double taxation are not mutually exclusive but rather can be combined. The use of one measure does not necessarily exclude the application of the other measures. The use of tax treaties might especially be considered relevant if international tax coordination (such as through OECD International VAT/GST Guidelines) proves to be ineffective or insufficient. In any way, the development of such guidelines will provide a useful basis for the development of a VAT/GST model tax convention as they are expected to represent internationally agreed principles.

But if states decided to agree on VAT/GST treaties, what should these tax treaties look like? How should they work and how should they be structured? What should be their scope, and who should get a right to tax? These are questions that will be dealt in this paper. The drafting of a complete model tax treaty is not realistic at this point

¹¹ See, for example, the former practice of the Austrian Ministry of Finance until the Austrian Supreme Administrative Court (hereinafter VwGH) decided differently (see VwGH, 29 January 2008, 95/15/0043, *Österreichische Steuerzeitung* 1998, p. 609 et seq.).

¹² OECD, *International VAT/GST Guidelines* (OECD VAT/GST Guidelines), February 2006.

¹³ See e.g. Williams, *Trends in International Taxation* (1991), p. 170; White, "The Serious Research Gap on VAT/GST: A New Zealand Perspective after 20 years of GST", *IBFD International VAT Monitor* 2007, p. 343 (p. 349); Arnold/Sasseville/Zolt, "Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century", *IBFD Bulletin for International Taxation* 2002, p. 233 (p. 235); Erikson, *Intertax* 2005, p. 166 et seq.; Westberg, *Cross-Border Taxation of E-Commerce* (2002) pp. 177 and 242; Westberg, *Nordisk Mervärdesskatterät* (1994) pp. 511 and 525; Angel Gurría and Jeffrey Owens, both at the 50th Anniversary of the OECD Model Tax Convention conference in Paris on 8 September 2008 (see e.g. OECD, *Conference on the 50th Anniversary of the OECD Model Tax Convention, remarks by Angel Gurría*, 2008); see also some of the contributions in this book.

as we are only at the beginning of the scientific discourse on this topic.¹⁴ I will rather try to address some basic points, identify issues that have to be dealt with, show possible solutions, and make some suggestions on how such a VAT/GST tax treaty could be shaped. This paper should be understood as a starting point for discussion rather than as a complete proposal. It is meant to be a first step to close the “research gap”¹⁵ on consumption tax treaties.

III. Income tax treaties as starting point for development of a VAT/GST treaty

1. Use of concept and structure of income tax treaties

Currently, there are no consumption tax treaties in place¹⁶ which could serve as a model for such VAT/GST treaties. Therefore, when designing a new VAT/GST Model Convention, it seems obvious to start with something that already exists and is already broadly accepted: income tax treaties. Although income taxes and indirect taxes are very different, the underlying ideas of such income tax treaties and — going even further — their concept and structure should be analysed to see if they can be used for VAT/GST treaty purposes.

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3. Personal scope in separate independent VAT/GST treaties

In case states prefer to develop independent VAT/GST treaties, separate from income tax treaties, the issue of a restriction of the personal scope of these treaties arises as well. Should treaty applicability be made dependent on residence of a taxpayer (or any other person) in one of the contracting states? Is a limitation of the personal scope necessary or desirable at all?

If states decided that they do not want to make treaty application dependent on the residence of the taxpayer (e.g. for reasons mentioned in the previous section), it has to be analysed whether the treaty scope should be limited to other persons resident in one of the contracting states. Again, a difference between income taxes and VAT/GST may become an issue in this respect. Simply put, income taxes only know two connecting factors that allow taxation in a state: the person that derives the income and the source of the income. In contrast, VAT/GST generally knows three connecting factors that may allow taxation of a supply: the supplier, the customer and the “source” (i.e. for instance the place of performance or where property is situated, etc.). This phenomenon, however, is not unique to VAT/GST. There are also other taxes that use three connecting factors for taxation. And some of these taxes are also covered by tax treaties. Inheritance taxes, for instance, usually view the deceased, the heir (or legatee) and again the “source” (i.e. certain property such as immovable

¹⁴ Eriksen accurately sees the international VAT environment in an “embryonic stage” compared to the international income tax environment (see Erikson, *Intertax* 2005, p. 166).

¹⁵ See e.g. White, *IBFD International VAT Monitor* 2007, pp. 343 et seq.

¹⁶ Admittedly, primary (together with secondary) EC law could be seen as treaties dealing with VAT. Furthermore, a few bilateral treaties mention VAT in respect of ships or aircraft in international traffic and some provisions of income tax treaties following the OECD Model are also applicable to VAT (see section **Error! Reference source not found.**, see also the contribution by Bourgeois/Römer, “Effects of Existing Tax Treaties on VAT (Relevance of Arts. 24–27 OECD Model for VAT/GST)”, in this book. But there are no comprehensive VAT/GST treaties that are comparable to income tax treaties (see Erikson, *Intertax* 2005, p. 166).

property) situated in their territory as connecting factors.¹⁷ Thus, it seems valuable to assess whether the path chosen for inheritance tax treaties may also be useful for VAT/GST treaty purposes.¹⁸

The OECD Estates, Inheritances and Gifts Model Convention does not refer to a “taxpayer” for the personal scope of the treaty but to the deceased. Art. 1 of this convention provides that it applies “to estates and inheritances where the deceased was domiciled, at the time of his death, in one or both of the Contracting States”. Transforming this solution to VAT/GST, this would mean that treaty application is made dependent solely on the residence (or location) of the supplier or solely on the residence (or location) of the customer. However, there is one difference between inheritance tax treaties and potential VAT/GST treaties that might cause problems in this respect. Inheritance tax treaties only have one main rule which refers to the same criterion (the deceased) as the rule governing the personal scope of the treaty. Inheritance tax treaties usually apply if the deceased is domiciled in one of the contracting states.¹⁹ At the same time, the main rule (if no exceptions are applied) allocates the right to tax to the state of domicile of the deceased. With respect to VAT/GST treaties, the situation could be different, especially if states were to use the 2010 EU place of supply rules as basis for VAT/GST treaty allocation rules. There would be two main rules for services (mainly depending on whether the supply is B2B or B2C) and again other rules for supplies of goods. So if, e.g. treaty entitlement would depend on the customer location and the main allocation rule for the supply in question (e.g. a B2C supply) would be the supplier location then there will be cases where double taxation cannot be effectively avoided despite the existence of tax treaties. The following cases should illustrate the issue:

Assume a supplier in state A performs services in state B for a customer in state C. There are tax treaties between all three states. The tax treaties only apply if the customer is located in one of the contracting states. As the customer is located in state C, only state C’s tax treaties are applicable. The treaty between state A and state B is not applicable. The treaties further provide for the supply in question that only the state where the supplier is located (main rule) has the right to levy tax unless the service is performed in the other contracting state (exception to the main rule). Following these allocation rules, state A’s and state B’s taxing rights are not restricted by the treaties concluded with state C. As the treaty between state A and state B is not applicable, consequently (if both state A and state B tax the supply under their domestic law) there would be double taxation even though there is a treaty in place between these two countries.

Under the OECD Estates, Inheritances and Gifts Model Convention this problem cannot occur. Both the personal scope provision of the convention and the main rule refer to the same person: the deceased. Thus, in a case where multiple states want to levy tax (e.g. because the deceased, the heir and immovable property are in different states), the treaties concluded by the state where the deceased was domiciled limit the taxing rights of all treaty partners except for the state where an exception to the main rule applies (e.g. where the immovable property is situated). Consequently, in a situation where all countries have concluded such treaties, it does

¹⁷ See e.g. OECD Commentary on the Model Double Taxation Convention on Estates and Inheritances and on Gifts, Introductory report by the Committee on Fiscal Affairs, paras. 19–20.

¹⁸ See also section 0.

¹⁹ See Art. 1 OECD Inheritance Tax Model.

not matter that the treaty between the heir's state and the state where the immovable property is situated, does not apply. The heir's state's taxing rights are already limited by the treaty concluded with the state where the deceased was domiciled.

To sum up, it has been shown that reference for treaty application to either only the supplier location or only the customer location might lead to situations where despite the existence of a tax treaty double taxation cannot always be avoided. This may happen if treaty allocation rules would follow two or more main rules (e.g. if they follow the two different main rules in the 2010 EU VAT system for B2B and B2C services). This could also happen — even if there is just one main rule — if not all states that claim taxing rights have concluded tax treaties with each other.²⁰ Thus, the issue remains how the personal scope of tax treaties should be limited. Should reference be made to the supplier, to the customer, or both? Or should VAT/GST treaties not be limited in their personal scope at all?

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5. Distributive rules

As already discussed,²¹ the use of distributive rules seems to be a well-suited way in a VAT/GST treaty to solve the conflict of competence between two or more states that would tax a transaction under their domestic law. Distributive rules generally limit the taxing rights of one or more of the contracting states. This is also the mechanism used in income tax treaties.

Income tax treaties contain in Art. 21 of the OECD Model a distributive rule that is applicable if all other distributive rules in the treaty are not applicable. Thus, it is a kind of catch-all clause.²² From its systematic function it can be compared to the main rule as identified for VAT purposes. It is applicable unless an “exception” is needed and consequently one of the other distributive rules (Arts. 6 to 20 of the OECD Model) is applied. The only problem is that, of course, for income tax the name “exceptions” would not really fit the other distributive rules as many of them are used more often than Art. 21 of the OECD Model.

A similar concept seems appropriate for potential VAT/GST treaties as well. It would be desirable to have a main rule and — where necessary — exceptions to the main rule. Whether or not a different set of distributive rules (and consequently different main rules) may be desirable depending on the kind of supply and the type of customer needs further analysis. As income tax treaty rules generally refer to “income”, “profits”, “gains”, “capital”, and the like, they are currently not suited to allocating the VAT/GST taxing right for a supply. Thus, for VAT/GST purposes,

²⁰ Imagine, e.g. a supplier in State A providing a service in State B for a customer in State C. Assume that all countries claim a taxing right under their domestic law on this supply. Further imagine that VAT/GST treaties have been concluded between State A and State B as well as between State B and State C. There is, however, no treaty between State A and State C. Further assume that in order for the treaties to apply, the treaties provide that the customer must be located in one of the contracting states. As a consequence, the treaty between State A and State B would not be applicable. Neither State A's nor State B's taxing rights would be limited by the applicable treaties. If now, for the service in question, the treaties allocate the taxing right to the state where the customer is located (main rule) unless the service is performed in the other contracting state (exception to the main rule), State B would keep its taxing right. Only State C would be limited in its taxing right. As a result, both State A and State B would not be limited in their taxing rights. Double taxation would occur although there is a treaty in place between these two states.

²¹ See sections 0.

²² See Vogel, DTC³, Art. 21 MN 19.

different, independent rules are needed or income tax rules would have to be adapted. For the development of independent allocation rules one should consider existing allocation rules. In this respect, the EU VAT system seems more useful as model for treaty allocation rules than, for example, the New Zealand system. The New Zealand rules merely decide on a yes/no basis whether the country applying the law has substantive jurisdiction. In contrast, the EU place of supply rules — at least for supplies within the Common Market — also decide which other country has substantive jurisdiction, in case the former country does not have substantive jurisdiction. Thus, the EU place of supply rules, as provided for in the EU VAT Directive, perform a more extensive allocation function.²³

The question of which allocation rules are the best suited for VAT/GST treaties needs further research. The decision should take into account the purpose and principles of VAT/GST and the rules should be neutral, efficient, certain and simple, effective and fair and flexible.²⁴

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IV. Conclusion

It has been shown that VAT/GST tax treaties, combined with measures of international cooperation, provide a useful instrument to tackle the problem of VAT/GST double taxation. The concept and structure of income tax treaties provide a good starting point for the discussion on how to shape such a VAT/GST treaty. As regards the scope of the treaty, adjustments have to be made since VAT/GST is an in rem tax and usually follows the territoriality principle. The question comes up to which persons the personal scope of the treaty should be limited. Should it refer to the taxpayer? Or should it refer to the supplier and/or customer? Or is there a limited personal scope useful for VAT/GST treaties at all? These issues have to be dealt with regardless of whether existing income tax treaties are extended to VAT/GST or whether a separate independent VAT/GST Model Convention is introduced. Furthermore, special attention has to be put on the risk of unintentional double non-taxation. It will be crucial for the political and factual success of potential VAT/GST treaties that this risk can be limited.

We are only at the beginning of the scientific discourse on avoidance of double taxation in VAT/GST and further research is needed. This paper covers only some of the issues that should be considered with respect to designing potential VAT/GST treaties. Of course, there are many more issues, such as the treatment of permanent establishments, or group taxation, just to mention a few. With this paper I hope to stimulate the scientific discourse on the elimination of consumption tax double taxation. It is meant to be a first step to close the “research gap” on this issue. And who knows, maybe 50 years from now there will even be 3,000 VAT/GST treaties... or a global one.

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See Millar, “Echoes of source and residence in VAT jurisdictional rules”, in this book, section III.2.1.

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See also OECD VAT/GST Guidelines, I.B. para. 6.