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Item 5 (n) of the provisional agenda

Indirect Taxes (other than health taxes)

Secretariat note

Summary

This note, which is *for decision*, considers the possibilities for more systematised UN Tax Committee guidance on indirect taxation issues, especially value added tax (VAT) /goods and services tax (GST) issues. It proposes, in view of the particular importance of indirect taxes to developing countries and the special characteristics and mandate of the Committee, that a multi-stakeholder Subcommittee be formed to study the issue and report back to the Twenty-fourth session on key priorities. This should include a proposed timeline for guidance from the Committee on a small number of issues likely to provide the most value addition to existing and other proposed guidance, especially for developing countries. This would be with a view to practical guidance being sequentially produced during the current 4-year Membership term. An initial focus on VAT/ GST issues is proposed.

For decision: whether a Subcommittee on Indirect Taxation should be formed, and if so, its mandate and composition.

Note that health taxes are addressed in a separate Conference Room Paper, CRP 35.

Background

1. Value added taxes (VATs) are an important source of domestic resource mobilization for most countries. VAT can be expected to grow in importance given: the capacity constraints on raising direct taxes; the fact that recently signed multilateral trade agreements will lead to a substantial reduction in tariffs; and that new technologies appear to be opening up new ways of ensuring better compliance with VAT. VAT may also play a useful role in shifting some elements of the informal sector into the formal sector.

2. The VAT is described well in various extracts from *The Modern VAT*¹, as follows:

Despite its name, the VAT is not generally intended to be a tax on value added as such: rather it is usually intended as a tax on consumption. Its essence is that it is charged at all stages of production, but with the provision of some mechanism enabling firms to offset the tax they have paid on their own purchases of goods and services against the tax they charge on their sales of goods and services. Although this characteristic feature is very clear-cut, the VATs observed in practice show considerable diversity as regards, among other things, the range of inputs for which tax offsetting is available and the range of economic activity to which the tax applies (that is, the base of the tax). Some major countries ... currently do not grant credits for taxes on capital goods purchases; moreover, of those that allow credits in respect of such purchases, some do not refund excess credits (any excess of tax paid on inputs over tax chargeable on outputs). Most countries exclude exports from the VAT, in the sense that tax is not charged on sales for export but tax paid on inputs is recoverable.

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As a result of the diversity of practice, there can be disagreement as to whether a given tax is properly called a VAT or not. For definiteness, though at the risk of creating the impression of an overly sharp dichotomy, we take a VAT to be: A broad-based tax levied on commodity sales up to and including, at least, the manufacturing stage, with systematic offsetting of tax charged on commodities purchased as inputs—except perhaps on capital goods—against that due on outputs.

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The key features of the Value-Added Tax are that it is a broad-based tax levied at multiple stages of production, with—crucially—taxes on inputs credited against taxes on output. That is, while sellers are required to charge the tax on all their sales, they can also claim a credit for taxes that they have been charged on their inputs. The advantage of such a system is that revenue is secured by being collected throughout the process of production—unlike a retail sales tax—but without distorting production decisions, as, in particular, a turnover tax does.

¹ Liam P. Ebrill, Michael Keen, and Victoria J Perry, *The Modern VAT* (2001) <https://www.elibrary.imf.org/view/books/071/07173-9781589060265-en/07173-9781589060265-en-book.xml> , at pp 1-3.

3. The issue of indirect taxes, especially VAT (defined broadly, to include GSTs²), was for a long time not part of the Committee's workplans, partly due to the initial general Committee focus on tax treaties, and the limited resources to expand into areas of activities that were often not part of Member's areas of expertise.
4. In recent years, with greater diversity of Committee experience and greater resourcing, there has been more attention in Committee discussions and guidance to VAT issues in the contexts of: (1) extractives³, (2) ensuring effective operation of the destination principle⁴ in an increasingly digitalized global economy, where OECD guidance on addressing the challenges for the collection of VAT on cross-border sales of digital products⁵ was looked to, (3) the interaction or otherwise between and permanent establishment concepts under treaties and (4) Government to Government aid programmes. A handbook on carbon taxes has also been produced.
5. The importance of value-added taxes (VATs) has increased as trade liberalization has reduced the number, amount and revenue role of tariffs, with less distorting VATs introduced to "compensated" for the loss in tariff revenues. Although VATs are often considered less distortionary than other taxes, there are still many issues to be resolved: how best to deal with the informal economy; the determination of the optimal small-business threshold for VAT registration; the most appropriate way to counter the regressive effects of a VAT, which has a disproportionate effect on the current spending of the poor; managing evasion and designing the VAT to minimize opportunities for fraud; as well dealing with VAT avoidance in practice.
6. Because VAT reporting tends to be monthly, bi-monthly, or quarterly, administration can be resource intensive. Resources also need to be devoted to preventing refund fraud, which can arise because VAT is refundable when a business has more input tax to deduct than output tax to pay (a situation that is common for exporters and seasonal businesses, but also arises whenever a business buys a significant capital asset).

² The OECD notes in *International VAT/GST Guidelines (2017)*

<https://www.oecd.org/tax/consumption/international-vat-gst-guidelines-9789264271401-en.htm>

at p.4 that: "The terms "value added tax" and "VAT" are used to refer to any national tax by whatever name or acronym it is known such as Goods and Services Tax (GST) that embodies the basic features of a value added tax, i.e. a broad-based tax on final consumption collected from, but in principle not borne by, businesses through a staged collection process, whatever method is used for determining the tax liability (e.g. invoice-credit method or subtraction method)."

³ There is a chapter on the subject in the *United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries (2017)* as well as in the forthcoming 2021 version.

⁴ That VATs are collected in the country where the final consumption of goods and services takes place, - achieved by taxing imports and refunding tax collected on the production of exported goods or services.

⁵ Notably the *International VAT/GST Guidelines (2017)* <https://www.oecd.org/tax/consumption/international-vat-gst-guidelines-9789264271401-en.htm>

7. There is important guidance provided by other international organizations including the OECD⁶, IMF⁷, World Bank Group⁸ and regional organizations such as CIAT⁹ and ATAF¹⁰. So the key issue is whether there are developing country and development-focused outcomes which could be well-targeted, practical and would be facilitated by Tax Committee guidance in this area, working with those other stakeholders and centres of expertise.

8. The potential value-add of Committee guidance in this area lies in:

- The convening power of the UN as a global body and its subsidiary bodies;
- The diversity of the Committee;
- The particular developing country orientation in the Committee's mandate; and
- Its ability to draw upon the expertise of others, including regional and other international organizations (such as the OECD and IMF), supporting and amplifying their best work, while forming an informed but independent view on issues where necessary, and articulating priority issues in the light of the realities and priorities of developing countries, especially the least developed.

9. To avoid unnecessary duplication and to limit the Committee and stakeholder resources needed, it is *not proposed* that the Committee provide *general guidelines* on indirect taxation generally or on VAT/GSTs, such as by producing a VAT Handbook.

10. It is proposed, instead, that a multi-stakeholder Subcommittee be formed to consider and report on issues of most relevance and urgency where the most UN value add could occur, and to thereby propose a small number of focused issues where practical guidance can be sequentially provided during the current term of Committee Memberships.

⁶ Including the general *International VAT/GST Guidelines (2017)* and guidance addressing BEPS risks from highly digitalized businesses structuring their affairs to pay little or no VAT on remotely delivered services and intangibles, as well as the broader tax challenges were associated with the collection of VAT on cross-border supplies of goods, services and intangibles from online sales, particularly cross-border B2C sales. See <https://www.oecd.org/going-digital/topics/tax/>

⁷ See, e.g., <https://www.imf.org/external/np/fad/tpaf/pages/vat.htm>. See also, at the IMF E-library, *The Modern VAT*, *supra* fn. 1.

⁸ Such as the OECD/CIAT/IDB/WBG joint *VAT Digital Toolkit for Latin America and the Caribbean* <https://www.oecd.org/tax/consumption/vat-digital-toolkit-for-latin-america-and-the-caribbean.htm>

⁹ See *supra* fn. 8.

¹⁰ ATAF, Digital Economy and Cross Border transactions : Valued-added Tax (VAT) Policy and Administration considerations for African Countries, available at https://events.ataftax.org/index.php?page=documents&func=view&document_id=78

Some Possible Specific Issues

(1) VAT/GST

11. The purpose of Committee work would be to provide focused practical guidance on key current indirect tax issues for developing countries, with a view especially to areas where certainty and ease of administration can be improved for governments but also taxpayers. Issues for consideration and guidance could include (with a recognition that the grouping of issues is purely for convenience, with no “hard characterization “ and some items relevant to more than one group):

(a) General issues

- **Countering regressivity** at the policy and administrative levels to ensure that no-one, particularly the less advantaged, is left behind by VAT systems, while recognizing the importance to VAT integrity of a broad base with few exceptions and special treatments. Is regressivity in practice (especially for the least developed countries) best addressed in VAT design (such as rate structures) or by matched non-VAT instruments?
- Possibilities or otherwise for **VAT simplification**, in a world of increasingly complex, digitalized and globalized business transactions, without opening up opportunities for abuse.
- **General design and drafting issues** – achieving the balance of sufficient certainty and a level of flexibility in the context of varying legal systems.¹¹
- What might be the **optimal small-business threshold** for countries in particular situations? Should thresholds vary according to the type of business, as is done in many countries?
- **Interaction between VAT and income tax** (and other taxes), including in an increasingly digitalized and globalized economy. This could address the role of VAT *place of establishment* concepts and their interactions with, *similarities to*, and *distinctions* from the income tax treaty “permanent establishment” concept). Work on this issue could spread across this agenda item and other agenda items such as agenda item 5 (i) on taxation issues relating to the digitalized and globalized economy).
- **What constitute good practices in measuring efficiency and fairness and why?**
- **VAT systems that work for small and medium-sized businesses** – including thresholds, simplified schemes that do not over-burden this sector of the economy; successful practices.

¹¹ See for example, along with other works cited in this paper, Richard Bird & Pierre Pascal Gendron, *The VAT in Developing and Transitional Countries*, (Cambridge University Press 2007). Rebecca Millar, ‘Jurisdictional Reach of VAT’ in Richard Krever (ed) *VAT in Africa*, Pretoria University Law Press (PULP) (2008) 175 – 214 - although written in 2008, its discussion of design issues, especially laws that leave many issues undetermined and create uncertainty, remains relevant.

- Dealing with **inbound payments from head office/ related companies**; applying cross border rules to multinationals in particular, understanding and applying the principle of neutrality.¹²
- **Dealing with non-residents**: especially in a highly digitalized and globalized global economy - collecting VAT on inbound services; inbound low-value goods and the interaction with the VAT on importations; ensuring refunds on outbound services; distinguishing (or not) between B2B and B2C suppliers.

(b) Records

- **Record keeping by taxpayers**, including business records of VAT owed and claimed (which may vary as between different types of business) as well as VAT invoices for supplies to other VAT-registered businesses, including in each case issues of necessary information and possible form, with a view to minimizing administration and taxpayer compliance requirements; dealing with cases where accounting practices are non-standard.
- There is a **related issue of to whom should tax invoices be issued, should they be required for all supplies**, and if so, are there benefits overall in requiring different documents for B2C supplies as compared with B2B supplies?
- **Digitalization of VAT records and procedures** and its possibility to streamline processes and reduce compliance burdens on both taxpayers and administrations, while assisting targeting fraud. This set of issues overlaps with agenda item 5(j) on digitalized tax administrations.

(c) Refunds

- The **functioning of effective VAT refund systems**: handling refunds, having funds available for them, vetting them to avoid fraudulent claims, paying them, reclaiming them, and in general balancing the risk of fraud with the need to provide a neutral tax for business.¹³
- Dealing with the **revenue risks** created by large and predictable refunds for businesses whose expenses are concentrated up front, with taxable outputs occurring later (particularly construction and capital-intensive startup businesses).
- Related to refunds (but broader, since it is relevant even to those with a net taxable position) **input tax credits**; the role of tax invoices, electronic invoicing, various methods of controlling invoices (government issued serial numbers, government issued paper invoices – including their relevance or otherwise in a digitalizing and increasingly paperless environment); partial apportionment (limitations on the extent of deductions when input tax relates partly to exempt supplies or private consumption).

¹² Neutrality is described in the OECD VAT/GST Guidelines as having “a number of dimensions, including the absence of discrimination in a tax environment that is unbiased and impartial and the elimination of undue tax burdens and disproportionate or inappropriate compliance costs for businesses. Neutrality is one of the principles that help to ensure the collection of the right amount of revenue by governments.”

¹³ See e.g., [Mario Pessoa](#) ; [Andrew Okello](#) ; [Artur Swistak](#) ; [Muyangwa Muyangwa](#) ; [Virginia Alonso-Albarran](#); [Vincent de Paul Koukpaizan](#), *How to Manage Value-Added Tax Refunds*, IMF Fiscal Affairs Division How to note, 10 May <https://www.imf.org/en/Publications/Fiscal-Affairs-Department-How-To-Notes/Issues/2021/05/10/How-to-Manage-Value-Added-Tax-Refunds-50357>

(d) Exemptions etc.

- **Exempt supplies and zero-rating:** including issues of policy choices,¹⁴ delineation of affected supplies and enforcement.
- Are more targeted alternatives, such as exempting from import tariffs raw materials and capital goods used to produce exports useful or are their benefits outweighed by the difficulty of ensuring that the exempted purchases will in fact be used as intended by the incentive?
- Do alternatives improve compliance and VAT collection, such as domestic **export production zones**, whose perimeters are secured by customs controls, **reverse charging** (where the customer is liable for the tax, rather than the supplier) or full or partial **withholding** (where the supplier remains liable for the VAT but the customer is required to withhold from the payment to the supplier and pay the withheld amount directly to the revenue authority)? Guidance on pros and cons of the alternatives in different situations may be helpful.
- **Risks (and how to address them) that the VAT becomes a race to the bottom** with countries shifting their use of incentives from the corporate tax to the VAT.

(e) Avoidance

- **Avoidance schemes:** identifying and dealing with them; designing and implementing a General Anti-Avoidance Rule (GAARs¹⁵).
- **Prosecutions, appeals, etc.**, especially first level internal revenue authority processes; Fines and administrative penalties; issues relating to constitutional powers of the revenue authority.
- **Dispute resolution options** more generally, bearing in mind existing UN guidance on dispute avoidance and resolution and any further Committee work. Recent work on dispute resolution in the Committee has focused on income tax disputes; The aim would be to examine the causes of VAT disputes, the existing mechanisms to resolve them and then to consider new ways to minimize and settle such cases.

(f) Sectoral issues

- **Tourism and VAT** issues, including lessons from developing country experiences.
- **Exemption and other options for financial services** – to what extent and in what respects is this an issue for developing countries, especially the least developed.
- **Dealing with industries having large upfront expenditures:** startup construction, real estate, and the risk of “phoenixing”¹⁶ and other forms of fraud.

¹⁴ A global movement in recent years caused many countries to introduce reduced or zero rates for sanitary protection products, while others direct any such receipts into related charities.

¹⁵ GAARS can apply to VAT: Waerzeggers, Christophe and Cory Hillier, 2016, “Introducing a general anti-avoidance rule (GAAR)—Ensuring that a GAAR achieves its purpose,” Tax Law IMF Technical Note 2016/1, IMF Legal Department. At p.2.

¹⁶ When a company's directors strip cash and assets from it, hide them, liquidate the company and then restart it (“phoenix” it, by reference to the mythical bird rising from the fire) usually under a different name.

- **Digital transactions** – Many developing countries are experiencing a rapid increase in digital transactions and ecommerce and are challenged about how to apply their VAT regimes to these transactions, especially when the supplier is overseas . Any initiatives here could focus on the special challenges faced in taxing such transaction in countries with less well-resourced administrations, and would build upon IMF and OECD work.
- **Extractives**, building upon work done as part of the United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries¹⁷ – with any work done being collaborative with any Extractives Subcommittee.
- How to deal with **government entities, charities, and donor-funded projects**.
- **Chain transactions, drop shipping** (where the seller purchases from a third party and has them ship directly to consumers) etc.

(g) *Relations with other countries*

- The scope for cross border cooperation in the area of VAT / GST, including how can countries build on existing exchange of information mechanisms and develop more effective ways to help them apply their VAT / GST rules, particularly on cross border transactions.
- Dealing with demands for reciprocity from other countries.

(2) **Excise taxes**

12. On the issue of excise taxes, the broad coverage of products (often for revenue reasons) has been the main difficulty. As noted by Tanzi and Lee in *Tax Policy for Developing Countries* (2001):

The economic rationale for imposing excises is different from that for imposing a general consumption tax. While the latter should be broadly based to maximize revenue with minimum distortion, the former should be highly selective, narrowly targeting a few goods mainly on the grounds that their consumption entails negative externalities on society (in other words, society at large pays a price for their use by individuals). The goods typically deemed to be excisable (tobacco, alcohol, petroleum products, and motor vehicles, for example) are few and usually inelastic in demand. A good excise system is invariably one that generates revenue (as a by-product) from a narrow base and with relatively low administrative costs.

13. While there will be some overlap in administration especially, with, e.g., VAT sometimes collected at the border by customs officials, in the light of the different issues and the component of this agenda item relating to health taxes, it is recommended that any Subcommittee formed should at least *not initially address excise taxes*, but should focus on VAT/GST issues, and should not address the health tax issue which is sufficiently important and distinct to be treated independently. It is the subject of a Conference Room Paper for separate consideration (CRP.35).

Recommendations

14. It is recommended that the Committee form a multistakeholder Subcommittee on Indirect Taxes with a mandate along the following lines:

“The Subcommittee is mandated to:

- Identify and consider for further work a small number of the more pressing indirect tax issues where guidance from the Committee may most usefully assist developing countries (and stakeholders in tax systems) in this area and initially report to the Committee on such issues at its Twenty-fourth session in 2022;
- Propose a workplan for sequential submission of draft guidance to the Committee for consideration and publication at various points during the current Membership of the Committee;
- In the first instance address VAT/ GST issues;
- Liaise with others active in considering these issues, including regional and other international organizations active in the field, seeking consistency of approaches where justified in the terms of this mandate and the Committee’s independent role as an expert group;
- Pay particular attention to opportunities for effectively designing and implementing indirect taxes, and report on current country practices, policy considerations and administrative issues;
- Consider all issues especially from the perspective of developing country realities and priorities;
- Formulate guidance on the risks of indirect taxes, including risks of regressivity, and successful practices in countering such risks; and
- Within the abovementioned context, provide draft guidance on such issues as are approved by the Committee at its sessions, with a view to approval and release of short, targeted guidance at various points during the current Membership terms of the Committee.

The Subcommittee shall report on its work at each session of the Committee.”

15. If the recommendation for forming a Subcommittee at the Twenty-third session is *not* followed, it is recommended instead that a small representative group of Committee Members (such as the Committee’s Bureau) report back on whether a subcommittee should be formed, issues of potential focus, and possible composition. It should provide a draft mandate for decision at the Twenty-fourth session.