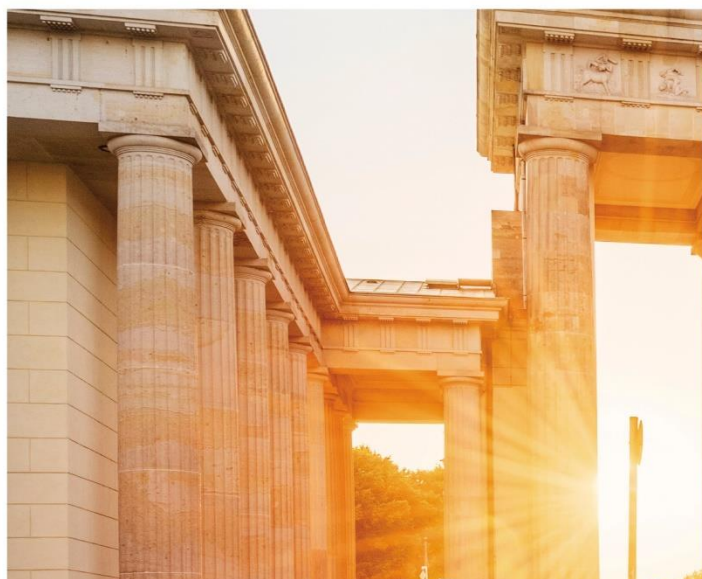


 **74<sup>th</sup> Congress of the International Fiscal Association in Berlin**  
4 – 8 September 2022  
[www.ifatax2022.com](http://www.ifatax2022.com)



# The VAT neutrality principle - practical issues -

Chair: Joachim Englisch  
Date: 8<sup>th</sup> of September 2022

# Agenda

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- Overview
- Complex distinctions
- Old rules meet new world: platform economy
- Inadequate procedures
- Anti-fraud regimes & doctrines
- Refund policy deficiencies
- Conclusions



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# Overview

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# VAT Neutrality: OECD Guidelines 2011 and 2016

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## Internal Neutrality

- The burden of VAT should not lie on taxable businesses, except where explicitly provided for in legislation.
  - *Implies input VAT deduction or refund*
- Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation.
- VAT rules should be framed in such a way that they are not the primary influence on business decisions.

## External neutrality

- With respect to the level of taxation, foreign businesses should not be disadvantaged nor advantaged compared to domestic businesses in the jurisdiction where the tax may be due or paid.
- Where specific administrative requirements for foreign businesses are deemed necessary, they should not create a disproportionate or inappropriate compliance burden for the businesses.

# Legal status of neutrality



## Principle is acknowledged in CJEU case law

- “The common system of VAT ensures complete neutrality of taxation of all economic activities”
  - “The right to deduct is an integral part of the VAT scheme and as a general rule may not be limited”
- “The directive aims to establish a VAT system that does not distort conditions of competition”
  - “That principle precludes [...] economic operators carrying out the same transactions from being treated differently”

## But taxpayers can rely on it only so far...

- “The principle of fiscal neutrality may be relied upon by a taxable person against a [non-harmonized] national provision”
  - See, e.g., CJEU C-309/06, M&S, § 34
  - Can the MS invoke overriding interests?
- BUT the neutrality principle “is not a rule of primary law which can condition the validity of [EU VAT legislation], but a principle of interpretation”
  - See, e.g., CJEU C-573/15, Oxycure, § 32

# Legal status of neutrality



## Drafting legislation...

- Neutrality is a foundational principle
- Draft legislation typically released as Ways and Means Motion which provides the proposed text and explanations
- Taxpayers can provide feedback to officials and politicians if neutrality is a concern
- Gives government officials the opportunity to address the concern

## Once legislation is passed into law, ...

- Court must apply law as drafted
- Neutrality plays a role in interpreting legislation but is not determinative
- If the interpretation results in a finding that violates the principles of neutrality and equality, only Parliament can address it
- A court can only recommend remission of the tax, penalties and interest – encouraged where the results are clearly inequitable or unfair

**Please vote:**

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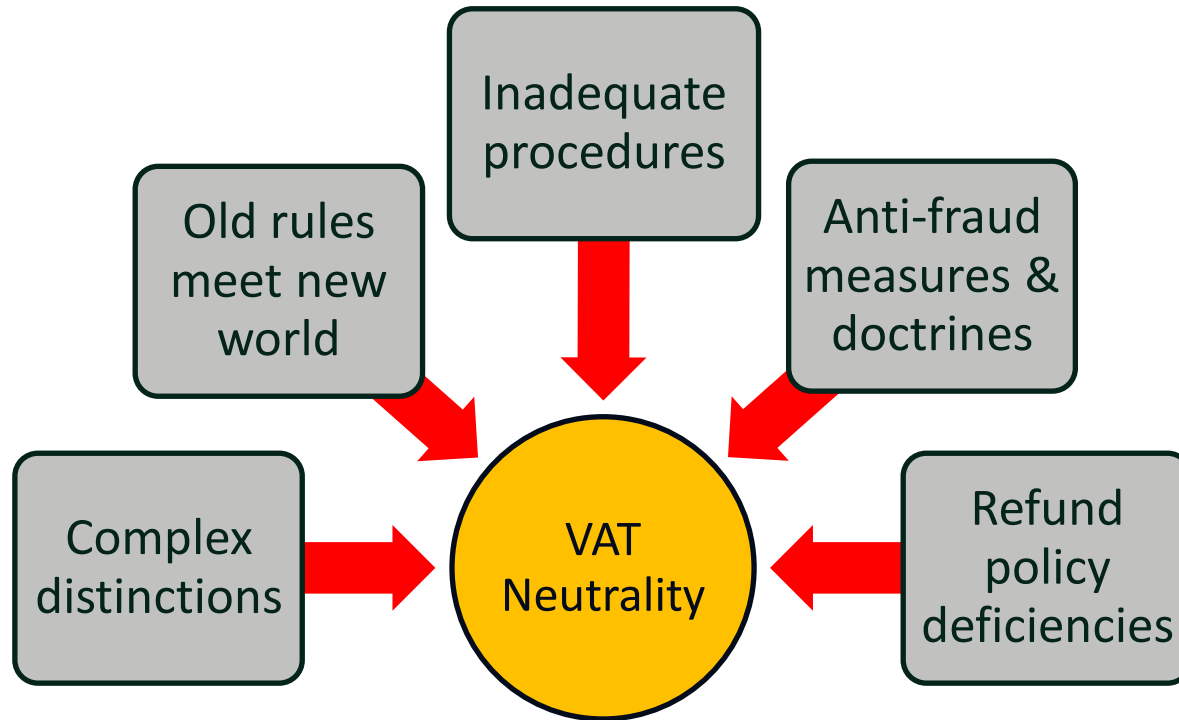
**What is the legal status of neutrality  
in your jurisdiction?**

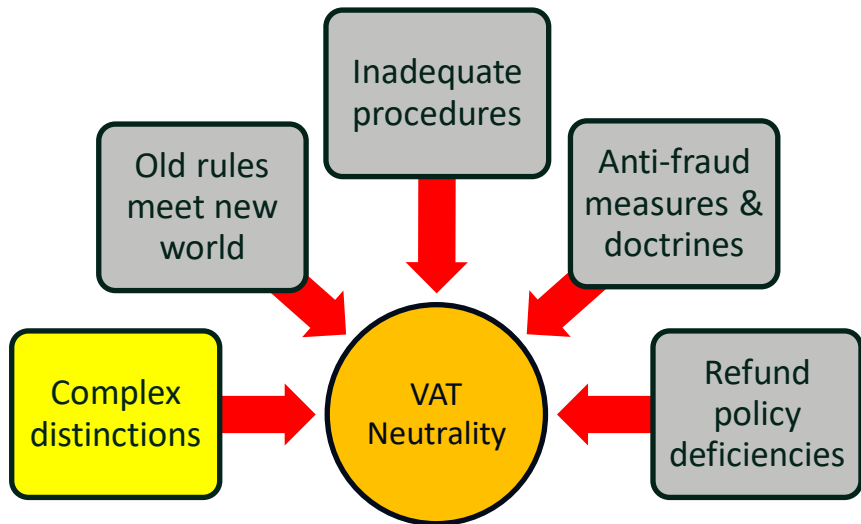
- a) Constitutional principle**
- b) Interpretative principle**
- c) Zero relevance**



# Limitations in practice

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## Complex distinctions

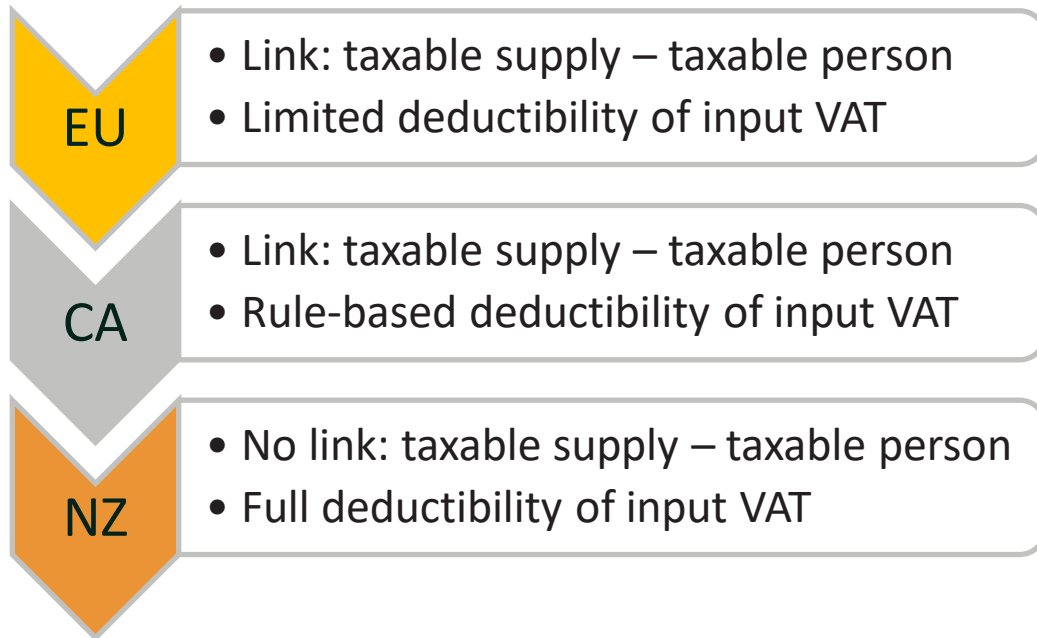
# Issues and reference areas

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- **Core problem:** fiscal neutrality has its limits in VAT design
  - Input VAT: private & other out-of-scope activities, exemptions without credit
  - Competitive neutrality: esp. selective tax relief measures
- Either justified, or problematic already conceptually
- **In practice**, these limitations are a source of additional *complexities & lack of neutrality*
  - Typically at the crossroads to “regular“ taxed transactions
- Reference areas to be discussed:
  - Holdings
  - Exemptions without credit
  - Rates

# Holdings

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- **In practice**, this gives rise to practical issues in a less neutral system
- Systems are based on different principles at the outset
- Deficient principles lead to non-neutral outcomes
- Leads to complicated rules to ensure neutrality

# Exemptions without credit

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- **The “original sin”: denial of input VAT deduction / input taxation**
  - Less pervasive in modern systems & often hard to justify
  - But in itself not necessarily a competitive issue for business
- **Complexities and *additional* lack of neutrality *in practice***
  - Controversial and/or inadequate *pro rata* formulas in case of mixed supplies
  - Complex yet still distortive adjustment rules for fixed assets
  - Insourcing incentive influences business behavior
  - Tax planning schemes benefit only the well-advised

# Case study: exemptions without credit – mixed supplies

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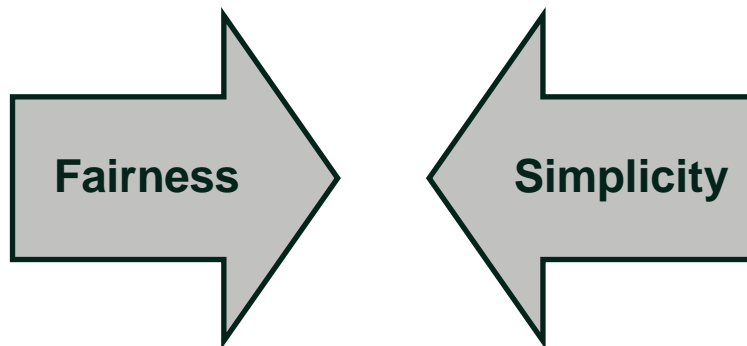


## Overview

- Legislation requires supplier to notionally sever that part of the business making exempt supplies
- Allocation rules differ based on what is being supplied and type of supplier
- Suppliers that are not financial institutions are allowed to use simpler allocation methods to determine credits
- Financial institutions are required to follow prescribed methods where the method is subject to approval by the Canada Revenue Agency who can substitute its method

# Tradeoff: deductibility of mixed supplies

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***Some distortions  
always remain!***

- Higher compliance costs (complexity)
  - Higher administrative costs
  - More adequate apportionment
  - Less planning
- Lower compliance costs
  - Lower administrative costs
  - Inadequate *pro rata* formulas
  - Incentivizes planning

# Rates: lack of neutrality

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- Approx. 50 % of countries around the world apply reduced rates
- Generally:
  - Traditional (older) VATs have more rate differentiation
  - Modern VATs (post-1980) have less rate differentiation
- But there are exceptions to this rule (e.g. China, India)
- Even countries with one-single rate apply exemptions (except NZ)



# Rates: lack of neutrality

**Pringles:**  
Potato crisps  
or snacks?



**Stem cells:**  
Healthcare  
or not?



**E-books:**  
Books or  
not?



**Tampon  
book:** Book  
or tampon?

# Rates: lack of *de facto* neutrality

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- What are the consequences of multiple rates?
  - For businesses: increased **compliance costs**
  - For tax administrations: increased **administrative costs, risk of avoidance and fraud**
  - Overall: a **loss of *de facto* neutrality**



# Rates: how do tax administrations cope?

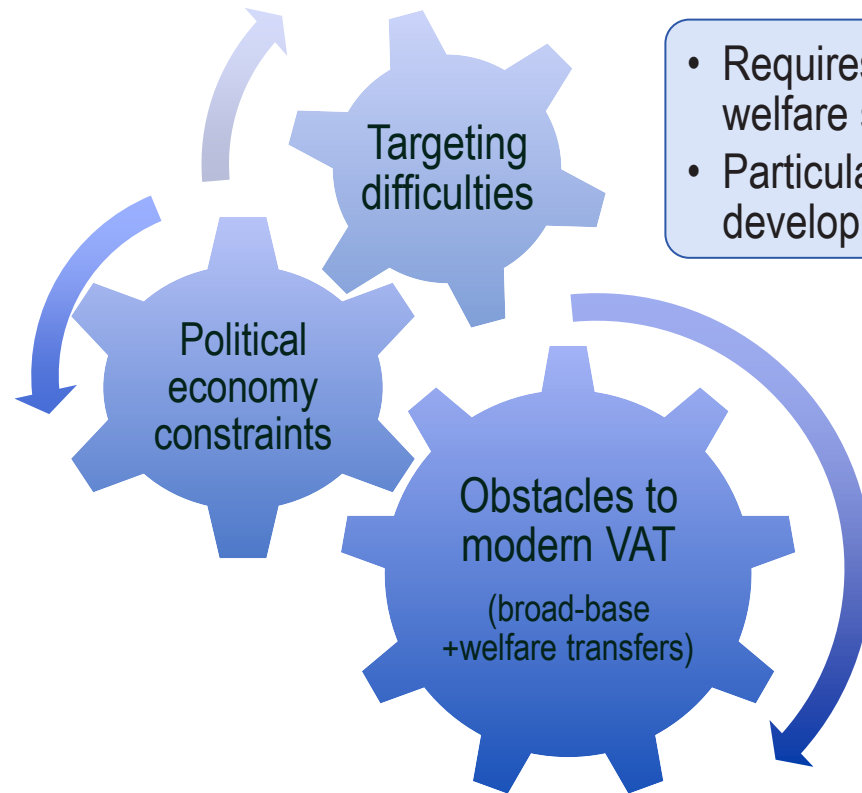
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## Example Poland

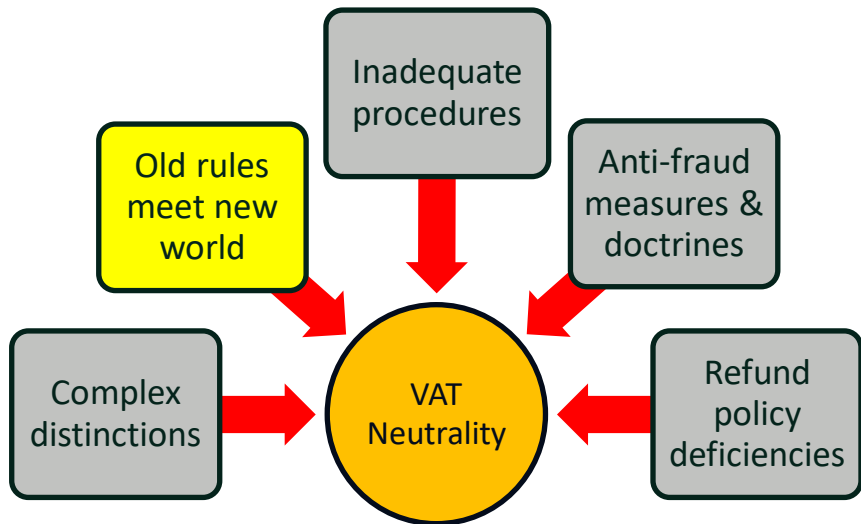
- **Binding Rates Information (BRI) or binding tax rulings** regarding rates may cause significant competitive advantages for some taxpayers, who offer identical or similar products to those offered by other suppliers.
- In Poland, BRI and binding rulings **protect** taxable persons until they are changed or the respective part of legislation is amended.
- That means that even if all competitors are obliged (because of the tax decisions or court verdicts) to apply the standard rate, the company that received a BRI or ruling may still use this favorable BRI/ruling until it is changed.

# Rates: why do we keep a distortive system?

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- Requires well-functioning welfare system
- Particularly difficult in developing countries

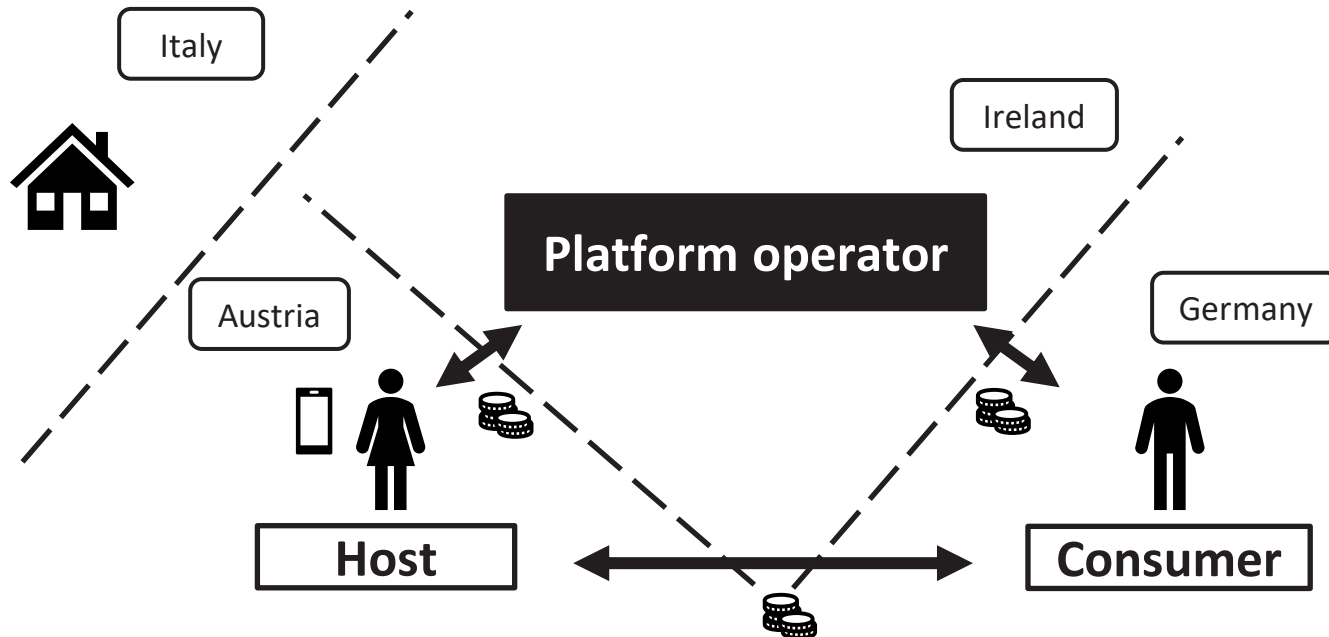


## Old rules meet new world

# Platform economy & traditional substantive rules

Lack of *de facto* competitive neutrality under traditional substantive VAT rules

Example



- **Who?**
- **What?**
- **To whom?**
- **Where?**

# Platform economy & traditional substantive rules

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## Lack of *de facto* competitive neutrality under traditional substantive VAT rules

- Current substantive VAT rules allow for varying interpretations
  - Varying VAT consequences
  - No legal certainty
  - *De facto* unfair competition
  
- Thresholds: taxable person / registration
  - Address regressivity of compliance costs
  - BUT: create specific issues for platform-based business models

# Platform economy & traditional collection models

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## *De facto* lack of competitive neutrality under the traditional VAT collection models

- Non-compliance gives rise to unfair competition
  - Sharing economy: low levels of compliance amongst vendors
  - E-commerce: fraudulent non-established vendors
- New VAT rules to foster compliance / mitigate enforcement risks
  - Information reporting obligations
  - Deemed supplier regimes
  - Presumptions of taxable person status for vendors
  - “One stop shop” (OSS)



# Special regimes: new neutrality issues?

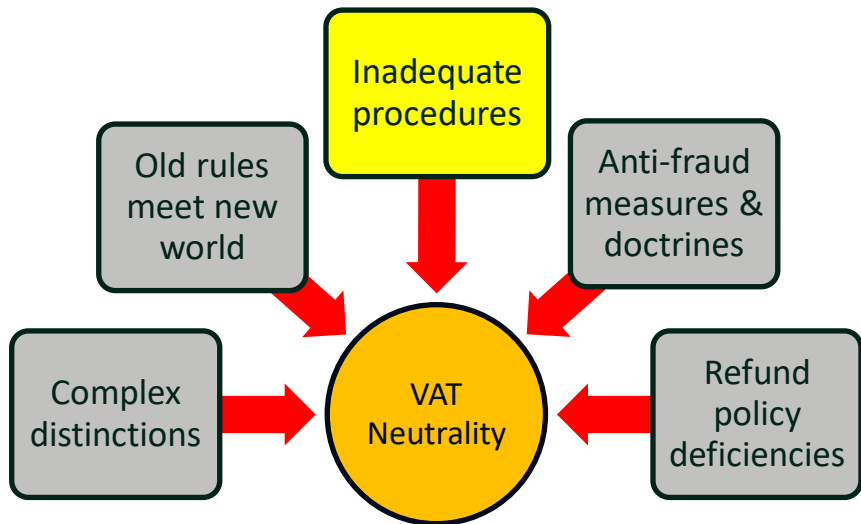
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- **Deemed supplier regime:** VAT liability is shifted onto the platform operator
  - Fosters compliance
- **Presumption of taxable person status**
- BUT:
  - Presumptions in line with channel neutrality?
  - Platform risk of irrecoverable VAT, if no involvement in the payment process
  - Platform risk of additional VAT claims in case of misclassification
- Important design choices

# Main takeaways

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- **Lack of competitive neutrality can be caused by**
  - Applying traditional rules to the platform economy
    - Between suppliers of analog and platform-based business models
    - As well as between suppliers of platform-based business models
  - Non-compliance of vendors in the platform economy
- **Well-designed special regimes can reduce non-neutrality**
- BUT: risk of causing new non-neutralities



## Inadequate procedures

# Inadequate procedures: soft limitations

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- **Input VAT deduction, exemption with credit**
- **Procedural rules may affect neutrality**
  - Additional formal requirements making deduction difficult or affecting cash flow
  - Conflict with the standard rules of procedures
  - No or delayed refunds, with or without interest
  - Refunds to non-established entities: less advantageous conditions
  - Statute of limitations: different periods

# Excessive formalism: input VAT

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**National legislation introduces disproportionate formal requirements, which do not generally preclude input VAT deduction, but may *de facto* affect neutrality**

- **Example:** Polish rules on input VAT deduction in a case of intra-EU acquisition
  - A right to deduct has arisen, but its exercise is made subject to the additional requirement of receiving an invoice
  - If no invoice has been received within three months, the input VAT deduction is denied
  - Need to make a payment of output VAT
  - Risk of sanctions and interest payments: revenue maximization
  - *The law was changed only after CJEU decision, in which the Court stated that the rule is not in line with the neutrality principle*

# Neutrality ripple-effect of *ex post* adjustments

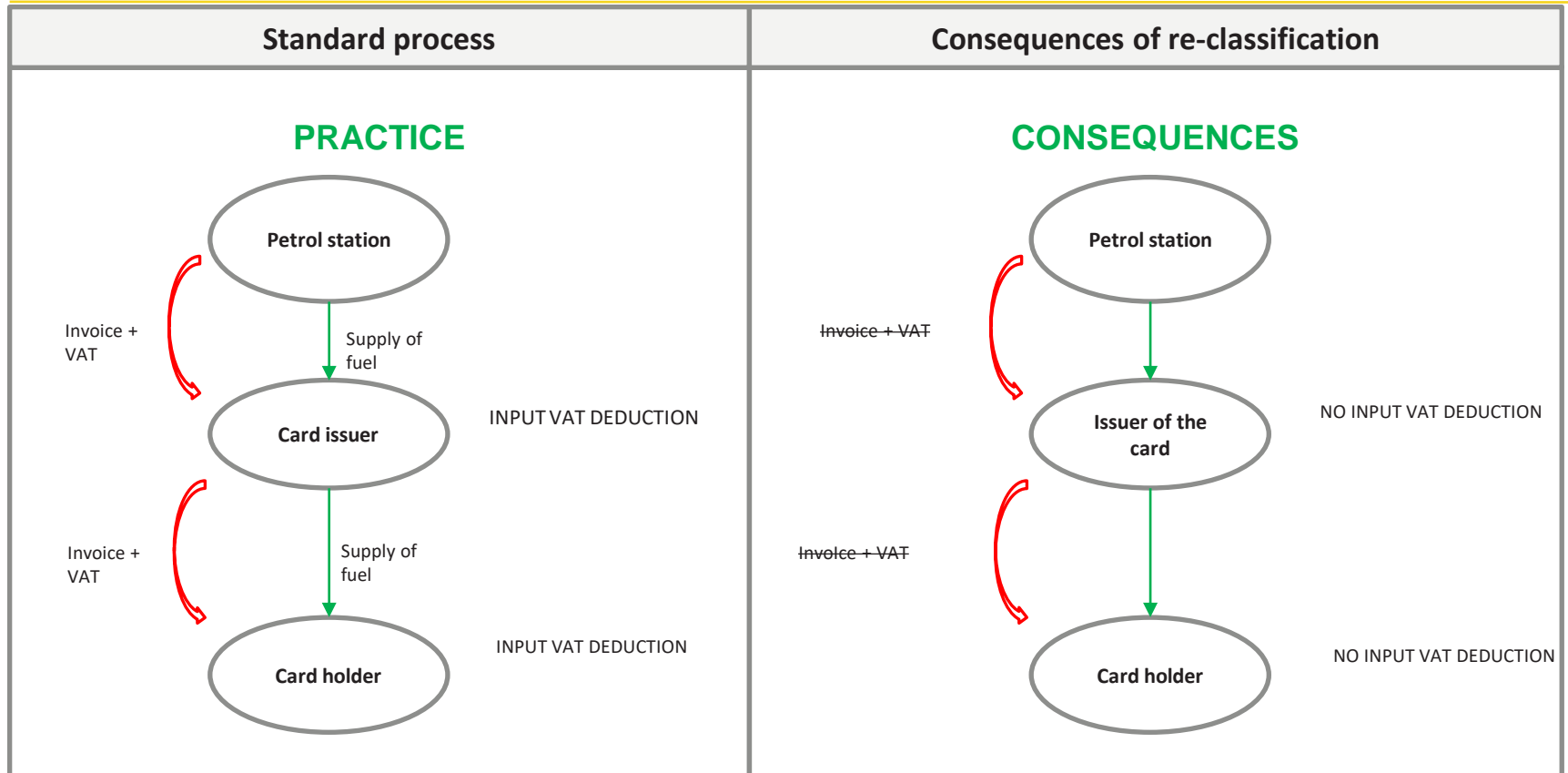
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## Re-classification of a transaction and its consequences

- Tax authorities re-classify transactions, changing practice commonly applied by the businesses and for long time accepted by the authorities.
- Re-classification of transaction may cause several consequences such as – tax arrears, no input VAT deduction, penal interests, sanctions/penalties etc.
- This risk may apply in a case where there was no fraud, no abuse, VAT was settled properly (as per initial classification) and there was no loss of state revenues.

## Example: fuel cards and CJEU jurisprudence

# Neutrality ripple-effect: example fuel cards



# Time-limits on neutrality: procedural preclusions

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- Some states **do not allow to make any correction** during the tax audit or after the audit (audited period is closed for good)
- This may conflict with rules on the temporal allocation of input VAT claims
  - If an input VAT deduction may be made only in a given period and this period was already audited, no subsequent correction can be made for this period
  - Especially problematic, if combined with high degree of formalism regarding invoices as a determinant of input VAT timing



# Lack of neutrality of simplified registration schemes

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- **Canada:** two registration systems affecting input tax credit rights:
  1. Regular registration, which allows for input tax credits
  2. Simplified registration by non-residents supplying IPP or services to consumers, BUT: no input tax credits
- **EU:** Similar issue also internally, with the OSS registration scheme

# More onerous regular registration for foreign traders

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## Example: Registration for GST/HST in Canada

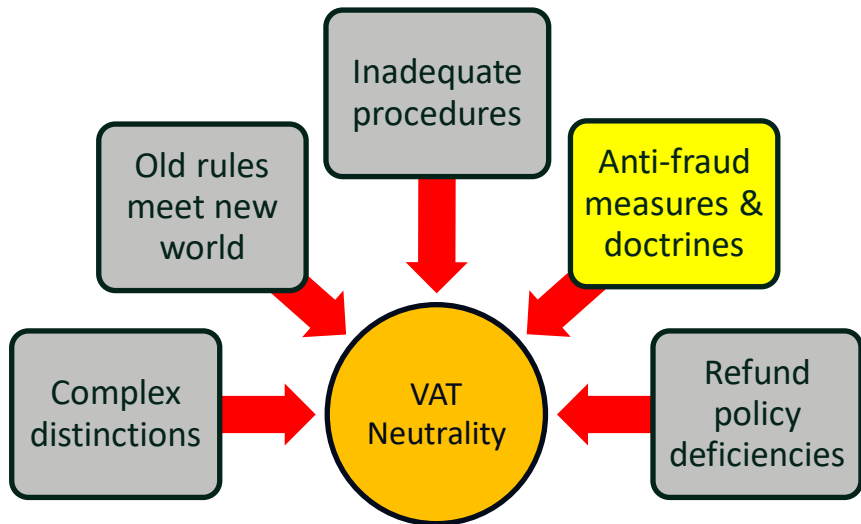


- **Residents: easy to register**
- **Non-residents:**
  - Must be able to show that they qualify for registration and if seeking credits, post security
  - Administratively more challenging with non-residents seeking full registration which allows for credits face months of delay
  - Simplified registration for suppliers of IPP and services does not allow for credits started July 2021; still facing delays in having registration approved
    - CRA will generally agree to retroactive registration if person is making taxable supplies

# Main takeaways

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- The neutrality is often at risk because of the **procedures, practicalities, “minor” technical regulations**.
- Additional formal requirements resulting in unavoidable tax arrears, procedural rules making input VAT deduction excessively difficult etc. create **additional financial costs for taxpayers**.
- Additional cost of compliance, penal interests and sanctions **effectively decrease the amounts factually recovered**.
- Input VAT recovery **is particularly burdensome for non-residents**.



## Anti-fraud regimes & doctrines

# Anti-fraud regimes and doctrines

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- **Anti-fraud regimes...**
  - sit between substantive and procedural law issues
  - are an important reason for lack of neutrality in VAT practice
  - especially where they give rise to excessive compliance costs or formalism (e.g. VAT registration, invoices, documentation requirements, reporting obligations...)
- A proportionate equilibrium should be ensured in order to protect different values
  - Protection of VAT revenue and a level playing field
  - vs. the freedom to conduct a business without excessive compliance costs and risks
- **Examples:**
  - Split payment mechanism
  - Due diligence procedure in a case of carousel fraud / missing trader

# Anti-fraud doctrine to combat missing trader fraud

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- **CJEU: no input VAT / exemptions in case of “bad faith”** regarding fraud in the transaction chain
  - Applies also to those who failed the “should have known” test
  - In itself already an excessive test (no link to damage done; disproportionate risks)
- **Additional issues arise in practice:**
  - Across-the-board implication of all taxable persons involved in the transaction chain; typical argument: no proper care – no deduction
  - Some tax authorities treat use of own guidelines on verification procedures as informal condition of input VAT deduction in a case where fraud in the chain was detected

**Please vote:**

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**Can vendors be made responsible for fraud committed by others in your jurisdiction?**

- a) EU**
- b) Non-EU: yes**
- c) Non-EU: no**

# Split payment mechanism

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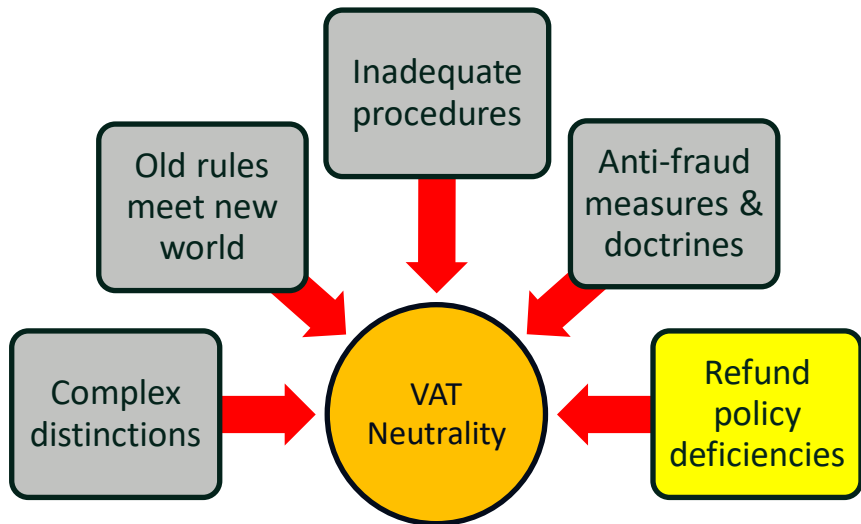
- **Split payment:** several variations, same principle – buyer pays the amount of VAT resulting from the transaction / invoice on the specific account
- If the payment is made:
  - directly on the account of the tax authorities, and
  - not all transactions are subject to split payment,  
the supplier may be in a position where his/her deductible input VAT is higher than his/her declared output VAT just because output was already paid to the government by the buyer.
- So pure offset is not possible.
- If there is no fast and effective method of direct refunds, taxpayers face permanent cash flow difficulties being a result of this mechanism.



# Main takeaways

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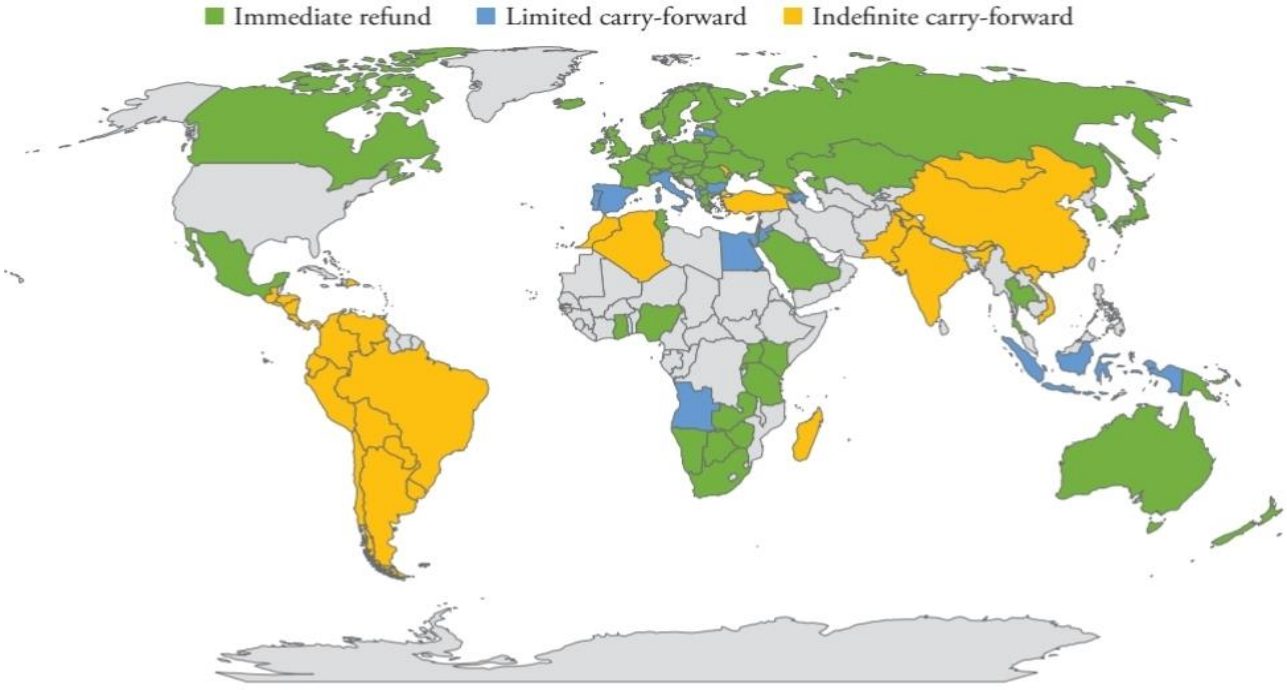
- **Anti-fraud measures are clearly needed**
- Current approach emphasizes revenue maximization (e.g. third-party liability)
- Creates issues with rule of law, tax morale and neutrality (distortions, costs, risks)
- Focus should be uniform tax law enforcement vis-à-vis **fraudsters**



## Refund policy deficiencies

# Input VAT deduction: refund policy limitations

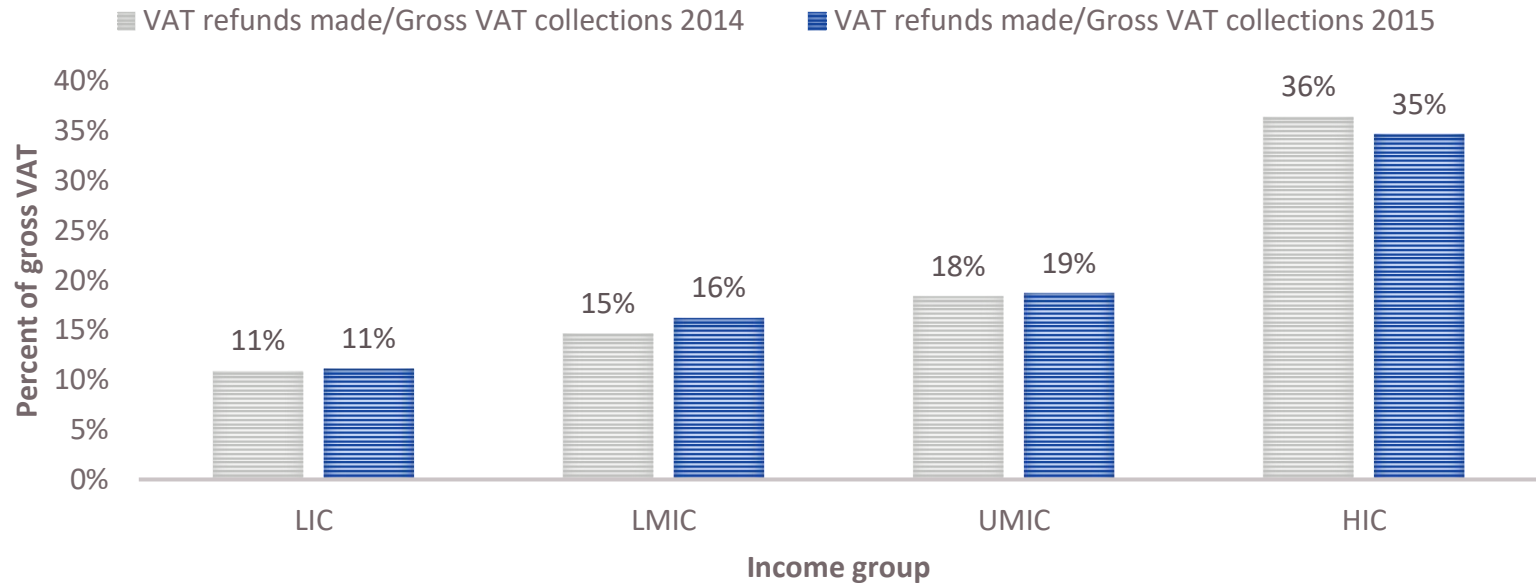
## VAT Refunds Mechanism (2019)



Source: IMF, 2022

# Input VAT deduction: refund policy limitations

## Level of VAT Refunds by Country Income Group (2014-15)



Source: IMF, 2022

# Case study: input VAT deduction – refund policy limitations

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- **Refunds exceed 50 %** of gross VAT collections – largely because of exports
- Legislation requires prescribed documentation to support credits – for example, valid names on purchase documents – concern for supplies paid by related entities / holding entities
- Claiming of credits is the **most common audit issue**
- Credit returns, particularly filed by non-resident suppliers subject to increased scrutiny that often results in **delays in payment**
- Delayed payment can result in significant foreign exchange losses

# Input VAT deduction: refund policy limitations

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- **Why do countries not give VAT refunds?**
  - (Perceived) risk of **fraud**, linked to low administrative capacity
  - **Cash flow** problems, and a fundamental confusion between net and gross VAT
- **What are the consequences of not giving refunds?**
  - For businesses: **increased costs**
  - For countries: environment **less appealing for investment**
  - Overall: a **loss of *de facto* neutrality**



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# Conclusions

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# VAT neutrality: holistic approach

Substantive  
law

Procedural  
law

Administrative  
Practice



Multitude of VAT neutrality shortcomings in practice