BEPS: the indirect tax impact

Indirect Tax | International Tax



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Mark Junkin and *Aili Nurk* review the BEPs project and its potential effect on indirect taxation for businesses

Key Points

What is the issue?

The link between BEPS and indirect tax is not immediately obvious, with only action 1 mentioning ‘VAT’. But BEPS will have a significant bearing on the indirect tax profile and compliance obligations of international businesses

What does it mean for me?

Around the world indirect taxes are growing in scope and complexity. It is important to plan effectively and maintain indirect tax compliance

What can I take away?

Tax advisers need to collaborate when advising on the implications of the BEPS changes. Considering the indirect tax angles early in the process will help business to identify and mitigate risk

Towards the end of 2015 the G20 finance ministers met in Lima to endorse the final package of measures outlining consensus actions under the Base Erosion and Profit Shifting (BEPS) project, which was published by the OECD Secretariat ahead of the G20 meeting.

Sixty-two countries, including a number of developing countries, have collaborated in the G20/OECD-led BEPS project and they have agreed to continue working together at least until 2020.

Since the meeting in Lima we have seen a variety of steps being taken by governments to begin to implement the changes, including the UK. Whilst the implementation of BEPS changes will be phased over coming years, some actions will take effect immediately, such as the new transfer pricing approach and country-by-country reporting. Some actions will need national legislative changes taking

effect from 2017 or later (hybrid mismatches and interest restrictions) and some actions will first require amendments to double tax treaties (permanent establishment, treaty abuse and dispute resolution).

The changes announced will have a significant impact on multinationals and their cross-border trading activities. Changes to core corporate income tax and transfer pricing principles are well-known and highly publicised.

The impact of the BEPS changes on indirect taxation is less well defined but should not be over-looked as it is important that the effects are understood and compliance is maintained. In particular, changes to transfer pricing and permanent establishment rules may cause some businesses to re-evaluate their business strategy and supply chain models, which could naturally have significant VAT and customs duty implications.

BEPS actions and indirect tax

The BEPS project is bringing about fundamental changes to international taxation, looking at international corporate tax aspects in areas such as the Model Tax Convention and Transfer Pricing Guidelines. Only one of the BEPS actions specifically mentions VAT (action 1: Addressing the tax challenges of the digital economy). It is clear, however, that international action on BEPS will impact the pre-existing indirect tax profile of businesses.

From an indirect tax perspective, many of the key areas for consideration relate to international business models and supply chains and will include the following:

- changes to place of supply;
- new or revised VAT registration and declaration obligations;
- cost and cashflow implications, including customs duty and VAT recovery issues;
- customs valuation changes and/or loss of reliefs;
- challenges around operational supply chain efficiency and movements of goods;
- changes to VAT thresholds (eg on low value import of goods);
- possible indirect consequences of changes to the definition of corporate tax permanent establishment; and

- making sure any new supply chain is ‘wired’ correctly into enterprise resource planning systems for indirect tax purposes, commonly a very challenging, costly and time consuming exercise.

We summarise below some key aspects of the BEPS actions with the greatest capacity to have an indirect tax impact.

Addressing the tax challenges of the digital economy (action 1)

BEPS action 1 contains significant coverage of VAT and is also clearly linked to all the other BEPS actions, since the G20/OECD considers that ‘there is no separate digital economy’.

In addition to extensive commentary on VAT core principles, BEPS opportunities and broader indirect tax challenges, the report includes new international VAT/goods and services tax (GST) guidelines for determining the place of taxation for cross-border supplies of services and intangibles, both business-to-business (B2B) and business-to-consumer (B2C). These recommend taxation at destination and VAT collection by reverse charge (B2B) or vendor registration (B2C). These guidelines were endorsed at the Global Forum on VAT in November 2015 by governments as a global standard on VAT/GST. However, many countries especially outside the OECD (including developing countries) have already started to implement the guideline principles into their national VAT systems. The report also contains a new study on the collection of VAT on the import of low value goods, which assesses the possibilities for reduction or removal of import exemption thresholds.

It is clear that mechanisms for registering overseas suppliers and collecting VAT on their sales to in-country recipients will add new compliance obligations for businesses. Many countries are trying hard to make these obligations as user-friendly as possible and avoid adversely affecting the market that already exists for such services. Indeed, the EU’s VAT Mini One Stop Shop for collecting VAT on supplies of digital content to consumers is generally viewed as a good model for an effective system. For countries outside Europe which are looking to introduce new VAT collection systems of their own, the key will be to balance the need to collect revenue on digital transactions against new, and potentially onerous, VAT compliance requirements that could make a particular market appear less attractive

to overseas businesses.

Permanent establishment – changes to the definition to prevent artificial avoidance

Businesses will be considering the effects of the report to identify the degree to which new permanent establishments (PE) could be deemed to exist. This is likely to include evaluating the degree to which international business models, supply chains and possibly finance structures are affected.

Where changes to business models and supply chains are envisaged, it is critical that indirect tax is a core component of these discussions in order to ensure that compliance is maintained and that any undesirable cost and cashflow implications are identified and mitigated where possible. Whilst indirect tax is not frequently a key driver in the case for change, it is certainly a business critical element in terms of delivery of the end result, particularly the maintenance of operational and transactional effectiveness.

The indirect tax aspects of corporate tax nexus discussions have been raised by businesses at a recent OECD advisory group on VAT and some further guidance may be considered at the OECD level. This will be useful because as things stand it is not yet clear what the VAT effects, if any, will be of changes to rules on the definition of PEs for corporate tax purposes. It is likely in practice that we may need to wait for individual tax authorities to decide, in the absence of any central guidance. One possible outcome is a closer alignment between the differing rules (in Europe at least) which determine when VAT and corporate tax establishments are deemed to exist. For example, if a business becomes established for VAT purposes (as a result of the crystallisation of a corporate tax PE), where previously that business was non-established for VAT, this could lead to significant changes in its VAT compliance profile, including VAT becoming chargeable on its supplies where it was not previously, as well as changes affecting the entitlement, or mechanism, for recovering VAT on its costs.

Transfer pricing–better alignment with ‘value creation’

As mentioned above, the OECD's latest report does not contain explicit references to VAT implications for businesses (apart from action 1). This is also the case in respect of commentary on transfer pricing changes.

It is clear that businesses will have to undertake reviews of pre-existing intra-group pricing and make changes to comply with new transfer pricing requirements. Such changes have a high likelihood of impacting the nature, degree and value of the inter-company transactions. Indeed, any activity which is fundamentally about revisiting and potentially re-characterising the legal and contractual relationships between parties will inevitably have a direct affect on transaction taxes.

For example, new transfer pricing requirements could mean revaluation of inter-company transactions for VAT and particularly customs duty purposes, with associated consequences in terms of compliance, invoicing and, potentially capacity for increased costs arising (where valuation increases).

Transfer pricing and indirect tax valuation principles have traditionally been complex to reconcile with one another and the proposed changes are unlikely to make this task any easier. For example, some countries, particularly outside Europe, will not look favourably on retrospective duty reclaims arising as a result of transfer pricing year-end adjustments where there has been a subsequent reduction in the value of previously imported goods.

Above all, it is important that any business evaluating the impact of the changes from a transfer pricing perspective also takes proper account of the impact on indirect tax, at both a strategic level, as well as on a transactional basis.

The indirect tax aspects of the above transfer pricing changes, especially year-end adjustments, have been recently discussed at the OECD advisory group as well as at the Global Forum on VAT and are included as a possible topic for the OECD work program for 2017-18.

Indirect tax collaboration

The OECD's BEPS project is a programme on international taxation, looking at international corporate tax, as well as the transfer pricing framework. For this reason it can be challenging to convey the impact that BEPS will have from an indirect tax perspective, particularly to non-indirect tax specialists.

However, the effects of BEPS are likely to be felt in many business areas, including operations, business models, procurement, supply chain, financing, ERP systems, customer and supplier relationships, and pricing. These are all areas where an indirect tax advisor tends to become involved.

Indirect tax professionals need to understand the specific application and relevance of BEPS to the businesses they advise and guide them through the complexity that lies ahead. Above all, tax advisors need to collaborate effectively to assess the impact of BEPS, identify areas of challenge particularly in the context of business change, and ensure that compliance is maintained in the future.