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Canadian Indirect Tax News

BEPS Action 1: VAT/GST developments

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On December 18, 2014 the Organisation for Economic Co-operation and development (OECD), as part of its work on base erosion and profit shifting (BEPS), released two discussion drafts on Action 1 relating to the tax challenges of the digital economy.

The OECD is developing international guidelines on value added tax/Goods and Services Tax (VAT/GST) to address issues of double taxation and unintended non-taxation resulting from inconsistencies in the application of VAT/GST to international trade. The first three chapters of these guidelines were approved in January 2014 and endorsed as a global standard at the second meeting of the OECD Global Forum on VAT in April 2014. Public comments are now invited on two new draft elements of the guidelines, relating to: the place of taxation of business-to-consumer supplies of services and intangibles (B2C guidelines) and provisions to support the application of the guidelines in practice (supporting provisions).

The discussion draft on the B2C guidelines responds to the key conclusion on VAT/GST in the Report on Tax Challenges of the Digital Economy, prepared in the context of BEPS Action 1, which concluded that the collection of VAT/GST in a B2C context is a pressing issue that must be addressed urgently to protect tax revenue and ensure parity of treatment between foreign and domestic suppliers.

Deloitte's comments

Many of the concepts in the discussion drafts are familiar to suppliers and taxpayers who make or receive supplies in Canada. With the previous introduction of Harmonized Sales Tax (HST) in British Columbia and Ontario in 2010 (the former of which subsequently de-harmonized on April 1, 2013), the provincial "place of supply" rules for supplies of services and intangibles made in Canada were significantly revised to place greater emphasis on the location of the recipient of the supply. These amended rules also provided for certain exceptions similar to those that are contemplated in the discussion drafts, including implementation of specific rules for personal services, services in relation to tangible or real property, passenger and freight transportation, telecommunication services, as well as computer-related services and internet access. The changes were implemented to generally ensure that GST/HST is applied, for supplies made in Canada, based on where the recipient is located and, thus, where the supply is presumed to be consumed. Many of the principles outlined in the discussion drafts, including use of information collected or obtained in the normal course of business, taxation based on destination principle, development of specific rules to address particular situations and the provision of detailed guidance by the tax authority are already addressed in Canada in the

GST/HST context. However, the “place of supply” rules for determining in the first instance whether supplies are made inside or outside of Canada could be impacted if the guidelines outlined in the discussion drafts are adopted. For example, the current place of supply rules to determine whether services are supplied in Canada are driven by whether any part of the service is performed in Canada. Adopting a rule based on where the recipient is located would mean significant changes to these place of supply rules.

Further, the discussion drafts also recognize that, at least in the B2C context, enforcement remains a challenge as reverse charge or self-assessment mechanisms generally do not work. Thus, the proposed solution of requiring vendors to engage in a simplified registration and remittance regime would have a great impact particularly as it relates to US vendors currently making supplies in Canada on a non-taxable basis by virtue of being non-registrants. While concessions to certain requirements are recommended with respect to a simplified registration scheme, there are country-specific requirements, such as the requirement for non-resident registrants to post security in Canada, that would be required to be addressed at the local country level should the actions be implemented.

Another issue of potential concern is in relation to B2C supplies that are not “on-the-spot”; basing the place of taxation on the customer’s usual residence presents challenges in determining consumption, particularly where use and enjoyment may lead to a different answer. Consider the example of certain telecommunication charges related to data roaming. If the tax were to be determined by the usual residence of the recipient, GST/HST may apply to roaming charges entirely consumed or used while the recipient is traveling outside of the country. If the person is traveling to the United States, local taxes may also apply as such taxes are not necessarily dictated by the guidelines for VATs. Within Canada, there are even challenges in minimizing double taxation across provincial borders given that a separate provincial sales tax (PST) regime also applies in certain provinces. As the guidelines in the discussion drafts pertain to VAT/GST, it is unlikely that they would impact the rules for taxation of goods and services for PST purposes, which are not currently aligned with the GST/HST rules (nor are the rules consistent among the PST provinces).

Practical issues regarding the IT systems and technology required by both businesses and tax administrations to ensure the effective implementation of the proposals must be considered. The experience in Canada, for example, has been that this has been a challenge, particularly given that there are various GST/HST rates across the provinces as well as various PST registrations, rules and rates to manage.

It remains to be seen how many countries will implement the proposals. Beyond Canada, some jurisdictions are moving in this direction, such as the European Union, Iceland and South Africa. However, the issue of how to implement an effective form of VAT/GST collection that does not prejudice wider commercial and investment concerns is a significant challenge. Ensuring this balance is achieved will be critical in implementing the guidelines.

It is important that taxpayers potentially affected by the OECD’s Discussion Drafts, and the guiding principles, consider the degree to which these may impact upon their business in the future, and, where appropriate, respond to the consultation to ensure their views and concerns are represented.

B2C guidelines

General principles

Under the VAT/GST guidelines, the destination principle is the core principle for determining the place of taxation for both business-to-business (B2B) and B2C supplies in an international context. The destination principle means that internationally-traded services should be taxed in the jurisdiction in which final consumption occurs.

In the past, achieving this was relatively straightforward, as services were generally consumed where they were performed. Accordingly, jurisdictions often determined taxation on the basis of where a supplier was located, as this was generally where the services were performed and consumed. However, the global economy - with an increase in the volume of digital supplies - has created challenges for this approach; the supplier's location or the place of performance is no longer necessarily a useful proxy for determining the place of taxation. For supplies of services where consumption does not necessarily bear a relationship to where the service is performed or where the supplier is located, a rule based on the customer's residence is often used as a proxy for determining the place of consumption. This rule ensures neutrality between domestic and foreign suppliers and is relatively easy for suppliers to comply with and tax administrations to administer.

Accordingly, the discussion draft recommends two general rules for determining the place of taxation for B2C supplies of services:

- For supplies that are physically performed at an identifiable location and ordinarily consumed where they are performed (on-the-spot supplies), a place of taxation based on the place of performance is recommended;
- For supplies that are not on-the-spot supplies, a place of taxation rule based on the customer's usual residence is recommended.

This results in allocating the taxing rights to the jurisdiction where (it can reasonably be assumed) the customer is located when consuming the supply.

On-the-spot supplies

For on-the-spot supplies, the place of physical performance of the supply is an appropriate proxy to determine the place of supply. Examples of such supplies include services physically performed on a person (such as hairdressing, beauty therapy, physiotherapy), accommodation, restaurant and catering services and entry to cultural and sporting events. The final consumption of these supplies generally requires the physical presence of both the person performing the supply and the person consuming it.

Other supplies

For other supplies, the place of usual residence of the customer is an appropriate proxy for the jurisdiction of consumption, as generally these services will be consumed where the customer has his/her residence. Examples of such supplies include: accounting and legal services, financial services and online supplies of software and digital content. To enable suppliers to determine the place of residence, tax administrations should provide clear and realistic guidance and suppliers should be able to rely on information routinely collected as part of their business activity.

The most effective and efficient approach to ensure collection of VAT/GST on cross-border B2C supplies is to require the non-resident supplier to register and account for VAT/GST in the jurisdiction of taxation. The discussion draft recommends that tax

administrations consider establishing a simplified registration and compliance regime for non-resident suppliers, and includes an annex setting out the main features of a simplified registration and compliance regime for non-resident suppliers. The discussion draft also advocates enhanced international cooperation between tax administrations in the area of indirect taxes, with a focus on the exchange of information and assistance in recovery.

Specific rules

In some situations, the general rules may not give an appropriate result, in respect of both B2C and B2B supplies. In these situations, specific rules may be necessary. The application of specific rules should be limited and should be supported by clear criteria.

The discussion draft does not set out when specific rules may apply, but provides the following guidelines (which should be considered together as a package) for evaluation of whether a specific rule is appropriate:

- Neutrality;
- Efficiency of compliance and administration;
- Certainty and simplicity;
- Effectiveness;
- Fairness.

The supply of services directly connected with real property is one situation where a specific rule may be appropriate, such that the right to tax is allocated to the jurisdiction in which the real property is located.

Supporting the guidelines in practice

The objective of the VAT/GST guidelines is to provide guidance to jurisdictions in developing practical legislation to facilitate a smooth interaction between national VAT/GST systems in their application to international trade, with a view to minimizing both double taxation and unintended non-taxation, as well as increasing certainty. The discussion draft states that this objective should be achieved through adherence to the internationally agreed principles on VAT/GST neutrality and implementation of the principles for determining the place of taxation.

The discussion draft acknowledges that while in an ideal world, achieving these objectives would be simple, in practice, differences between jurisdictions can create difficulties and disputes. The discussion draft therefore suggests mechanisms for avoiding double taxation and unintended non-taxation, for minimizing disputes and for dealing with evasion and avoidance.

Topics covered include:

- Mutual cooperation, exchange of information, and other arrangements allowing tax administrations to communicate and work together, including multilateral and bilateral cooperation.
- Taxpayer services, including readily accessible and easily understood guidance on the VAT/ GST rules and the creation of points of contact with tax administrations.
- Application of the guidelines in cases of evasion and avoidance.

Please contact your Deloitte indirect tax representative to discuss these changes further.

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