Minding the VAT Gap: Split Payment and Real-Time Taxation Insights from Latin America

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INTRODUCTION

The phrase "VAT fraud and error" sends a chill down the spines of government officials around the world. A recent investigation of valued added tax (VAT) collection problems in the UK conducted by the country's National Audit Office (NAO) finds that VAT fraud and error related to online transactions cost between £1 billion and £1.5 billion in lost tax revenue in 2015-16 or more given that the estimate "is subject to a high level of uncertainty."[1]

In response to this challenge, the UK appears keen on taking a page from the playbook of tax officials in Argentina and Ecuador and among other Latin American countries, by instituting a split payment approach to VAT collection. The method relies on card-payment technology to extract VAT at the time of purchase and then deposit the tax into government accounts. The UK tax-collection body, Her Majesty's Revenue and Customs (HMRC) is hardly alone in evaluating the use of split payment. In addition to unveiling a package of proposals in late in 2017 that called for "the biggest reform of [VAT] tax rules in a quarter of a century," the European Union (EU) has been assessing the viability of split payment for years.

In March, HMRC published a call for evidence seeking input on using payment industry technology to collect VAT on e-commerce transactions and immediately transfer the funds to the HRMC.[2] Notably, this "Consultation Document" represents a follow-up to the HRMC's march 2017 Consultation Document that collected general feedback on the feasibility of implementing split payment methodology to improve VAT-collection effectiveness.

The UK's consideration of a split payment approach is important to tax leaders within global companies for a couple of reasons. First, more tax jurisdictions around the world recognize that their traditional forms of VAT collection do not suffice as e-commerce and global sales continue to increase. As a result, tax executives should expect more countries to consider split payment and other alternatives to traditional VAT collection. Indeed, the HRMC's December 2017 report summarizing the responses it received to its 2017 Consultation Document notes that respondents identified split payment approaches that are being considered, or that already have been implemented, in Spain, Italy and Poland.[3] Second, the technology that supports the split payment approach also enables real-time taxation – whose viability a growing number of countries and their tax agencies are evaluating. This trend also warrants monitoring given that real-time taxation requirements would place new demands on tax functions and their tax technology systems.

The UK's consideration of split payment "will be of wider interest to taxpayers, advisers and banks/payment service providers," according to Tax Adviser magazine, "because it signals HMRC's interest in exploring a real time VAT collection mechanism which might then be rolled out to wider areas of VAT."[4]

On this count, the split payment approaches currently in use in Argentina, Ecuador and other Latin American countries are worth reviewing. A look at split payment in five of these countries follows a discussion of the UK's growing interest in split payment mechanisms.

Split payment methods, which some countries refer to as tax withholding mechanisms, are viewed by the UK as a way to significantly lower the VAT gap. Split Various Ways: Argentina, Ecuador and Other Approaches

MINDING THE GAP

While sizeable difference between the UK's expected VAT-collection revenue and the amount it actually collects each year sounds huge, many European Union (EU) countries fare far worse managing the so-called "VAT gap."

According to late-2017 EU research, the UK's VAT gap in 2015 was 10.88 percent (i.e., the country failed to collect 10.88 percent of the VAT it should have collected) while Italy endured a VAT gap of more than 25 percent. European Commissioner for Economic and Financial Affairs, Taxation and Customs Pierre Moscovici has asserted that EU member states lose tens of billions of euros in uncollected VAT revenue each year – a situation that he describes as "unacceptable." The EU research points to fraud and tax evasion, corporate insolvency, corporate bankruptcy, maladministration and legal tax optimization as the primary cause of VAT under-collection.[5]

HMRC's investigation into the UK's VAT losses specifies other causes, including as the rapid growth of cross-border e-commerce. As the number of overseas sellers to UK consumers multiplies, it has become more difficult for HMRC to monitor and enforce VAT registration requirements, particularly among smaller international sellers. This is the case, in large part, because VAT-collection processes, in the UK and many other countries, developed in the 1970s and 1980s have not kept pace with digital advancements. In the UK, "overseas sellers are required to register for VAT in the UK regardless of the level of sales," according to the HMRC report. "In these circumstances the seller must charge and collect VAT. Many overseas sellers are not VAT registered – or if they are VAT registered, they are not always collecting the appropriate amount of VAT. The government wants to ensure a level playing field, removing any unfair advantage to overseas sellers."[6]

SPLIT VARIOUS WAYS: ARGENTINA, ECUADOR AND OTHER APPROACHES

Although split payment approaches and mechanisms differ by country, the general concept is similar. Rather than relaying the full payment to the seller, the credit card, debit card or payment Services Company (i.e., the withholding agent") extracts the VAT from the transaction and immediately submits it directly to the government agency, typically a treasury organization. Whether the entire VAT amount or a portion of the VAT amount is submitted after the transaction varies according to a country's split-payment rules.

Given the digital nature of this approach, split payment mechanisms also help enable real-time reporting and monitoring activities that more tax authorities appear eager to conduct. "Many countries are investigating real-time reporting as a possibility for improving VAT and GST compliance," notes KPMG's Philippe Stephanny. "Brazil is arguably leading this movement, as the combined use of mandatory e-invoicing and the development of the public digital accounting system known as SPED (Sistema Publico de Escrituraçao Digital) is used to approve, store, and certify books and documents of commercial and tax bookkeeping. SPED also provides tax authorities a complete assessment of the tax accounting information in almost real time." [7]

Several of Brazil's neighboring countries have implemented split payment approaches for VAT collection, including the following:

Argentina

As the HMRC's March 2017 "Call for Evidence" report notes, Argentina assigns withholding agents responsibility for managing VAT withholding and for submitting the VAT that they collect to relevant tax authorities: "There are different withholding rates depending on the nature of the transaction. For example, different rates apply to goods and services compared to utilities and telecommunication." Payments made via credit cards are subject to these withholding rates; however, small businesses are not required to withhold VAT.[8]

All of the provincial jurisdictions in Argentina, as well as the City of Buenos Aires, impose a so-called "turnover tax" on certain activities, according to different rules. This withholding system applies to non-residents; prior to the recent implementation of these rules, foreign entities (those that did not operate subsidiaries in the country) were not subject to the turnover tax. Like other split payment approaches, the withholding – in some jurisdictions, such as the Province of Córdoba – must be conducted at the time of the payment.[9]

Noting that the Province of Córdoba's adoption of this withholding system my represent a new trend of provincial taxation of cross-border transactions, EY suggests that tax managers within global companies monitor these types of rules.[10]

This regime is only intended to generate funds via deposits made by the obliged subjects in the open accounts of the Nation's Bank, which are then used to ensure the payment of the tax obligations of the account holder.

Peru

More than a decade has passed since Peru implemented split payment methods. The most commonly used method is referred to as Sistema de Pago de Obligaciones Tributarias (SPOT). SPOT, which translates in English to Tax Obligation Payment System, was introduced in 2004 as a split payment method applicable to the purchase of goods. SPOT was quickly extended to services.

The SPOT regime operates with a special bank account in the Nation's Bank, which is created exclusively for tax purposes – unlike a normal, traditional commercial bank account. Each taxpayer must open a special account to be used exclusively to receive funds with the subsequent purpose of fulfilling fiscal obligations.

The regime works this way: When a taxpayer is about to pay its supplier in a transaction for a good or services, the corresponding amount is split and simultaneously deposited into two different bank accounts: the regular commercial bank account (which the seller operates on a daily basis) and the National Bank's special account. The percentage of the VAT portion varies depending on the nature of the good sold or the service provided. This deposits diverted to these special accounts are also known as "detractions."

This regime is only intended to generate funds via deposits made by the obliged subjects in the open accounts of the Nation's Bank, which are then used to ensure the payment of the tax obligations of the account holder.

In cases where the purchaser does not execute the detraction (i.e., fulfill the split deposit requirement), the purchaser cannot credit the input VAT on monthly tax returns.

Ecuador

Ecuador's split payment approach to VAT reflects recent as well as not-so-recent developments.

In June 2017, the country's new VAT took effect. The new rate of 12 percent marks a reduction from the previous 14 percent VAT rate. While there are certain exempt transactions, VAT is generally levied on the supply of goods and the provision of services as well as services received from overseas.[11]

Although companies must file VAT returns on a monthly basis, a portion of VAT payments are submitted to the government immediately after the transaction occurs. This approach is part of the VAT withholding framework that Ecuador adopted in 1997. The scheme designated all credit and debit card companies (along with some other companies, known as "special taxpayers") as withholding agents. The designation requires credit and debit card companies to split some, or all, of the VAT from the payment received – from an individual or a business – and immediately deposit those funds into the tax authority's account. In cases where the entire VAT is not immediately relayed to the government, the withholding submits the remainder of the VAT it withheld each month when it submits its VAT returns.[12]

Dominican Republic

The Dominican Republic enacted a split-payment VAT withholding system a dozen years ago, primarily in response to the increasing use of credit and debit card transactions. Withholding agents, which are known as acquisition companies, withhold 30 percent of the VAT on many transactions. This VAT withholding is reported to the country's VAT authority on a weekly basis. Many supplies, including medicine and educational services, are exempt from VAT withholding.[13]

Chile

Among all the different approaches split payment approaches that exist in Latin America, Chile likely has established the most interventionist model, when it comes to certain transactions between private parties and third parties. In addition to introducing the concept of the withholding agent several decades ago in its VAT Law, Chile also developed what is referred to as "Subject Change" in an effort to combat tax fraud and simplify the VAT administrative process of VAT.

As a general rule, the subject of VAT is the seller who is required to deliver to the fiscal treasury the tax of the operation (i.e., the output VAT). As a result of changing the subject, following the settings of the tax authority, this obligation of delivering to the fiscal service the aforementioned tax is now transferred to the buyer. This is significant as far as domestic operations are concerned.

Furthermore, for certain operations the transfer obligations transfer extend beyond that requirement: in addition to withholding the tax and entering the output VAT of the operation to the fiscal treasury, the same buyer is responsible for issuing the purchase invoice that supports the operation on behalf of the seller.

Withholdings are only made by withholding agents, those who are taxpayers and to whom Chile's Internal Tax Service has given the authority to withhold the VAT associated with the operations of purchases or sales of certain products or the provision of certain services. The amount of VAT withheld can be total or partial, depending on the nature or the good sold or the service rendered, and the percentages are established according to the different Resolutions the fiscal authority has published for that purpose.

Why the UK is Considering VAT Collection Alternatives: By the Numbers

- 1973: The year the UK's current VAT collection process was introduced.
- 12.8 percent: Average portion of VAT owed that went uncollected across all European Union member countries in 2015.
- 10X: The increase (tenfold) in online overseas businesses seeking to register for VAT in UK between 2015 and 2016.
- £1 billion – £1.5 billion: The amount of "VAT losses" related to online marketplaces that UK incurred in 2015-2016.

Sources: HMRC, NAO, European Commission

Conclusion

If, when and how the UK adopts a split payment approach similar to those already in effect in Argentina, Ecuador and other Latin American countries remains to be seen. Brexit certainly complicates the process of answering those questions. However, given the HMRC's recent, and steady, work on the topic and commitment to collecting stakeholder input, the introduction of split payment or a similar method of VAT collection appears to be a strong possibility.

As they monitor these developments in the UK, tax leader should keep in mind that many other countries are asking similar questions about updating their VAT-collection and enforcement approaches to keep pace with the rapid advance of global trade and online sales.

These issues also give rise to bigger and broader issues, as Fearnside emphasizes in her article. She notes that the UK's split payment report also "asks much broader questions about the feasibility of a real time VAT collection mechanism. Could this be HMRC testing the water for wider application in the future?"

As tax executives monitor split-payment developments, they should also keep their eyes on the increasing frequency with which government officials utter the phrase "real-time taxation."

ABOUT VERTEX

Vertex Inc., has been a leading provider of tax technology and services, enabling companies of all sizes to realize the full strategic potential of the tax function by automating and integrating tax processes, while leveraging advanced and predictive analytics of tax data. Vertex provides cloud-based, on-premise, and hosted solutions that can be tailored to specific industries for every major line of tax, including income, sales and consumer use, value added and payroll. Headquartered in Pennsylvania, Vertex is a privately held company that employs over 900 professionals and serves companies across the globe.

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END NOTES

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