



## **WORLD INFORMATION TECHNOLOGY AND SERVICES ALLIANCE STATEMENT**

### **VAT OUTSOURCING CONSIDERATIONS October 2003**

#### **Introduction**

The competitive business climate has put additional pressure on firms to reduce the cost of conducting business and becoming more efficient. The increasing reliance on technology coupled with its increased complexity has made outsourcing of information technology services a popular option.

However, the VAT exemption for industries and firms, particularly those in financial services and other high-value services, inhibits the use of outsourcing for information technology services by creating a price differential between the cost of contracting and performing services in-house. This, in turn, provides a disincentive for such firms to seek outside expertise and negatively impacts their competitiveness in the global marketplace. Since the global IT market in financial services exceeds US \$200 Billion, any disincentive for outsourcing is significant.

The World Information Technology and Services Alliance (WITSA) issued a previous Statement on this subject in 1999. This Statement updates the previous one and provides additional options for achieving VAT parity.

#### **World Information Technology and Services Alliance**

The World Information Technology and Services Alliance (WITSA) is a consortium of 49 information technology (IT) industry associations from economies around the world (list attached). As the global voice of the IT industry, WITSA is dedicated to:

- advocating policies that advance the industry's growth and development;
- facilitating international trade and investment in IT products and services;

- strengthening WITSA's national industry associations through the sharing of knowledge, experience, and critical information;
- providing members with a vast network of contacts in nearly every geographic region of the world; and
- hosting the World Congress on IT, the only industry sponsored global IT event.

Founded in 1978 and originally known as the World Computing Services Industry Association, WITSA has increasingly assumed an active advocacy role in international public policy issues affecting the creation of a robust global information infrastructure, including:

- increasing competition through open markets and regulatory reform;
- protecting intellectual property;
- reducing tariff and non-tariff trade barriers to IT goods and services; and safeguarding the viability and continued growth of the Internet and electronic commerce.

### **Impact of VAT Exemption on Cost of Procuring Services Externally**

The value-added tax is designed to impact the total cost of goods and services only once, although it is recovered at each stage of production. For example, a manufacturer pays VAT on goods and services it buys from its suppliers and charges a VAT when it sells the goods it produces. Subsequently, the manufacturer submits the two transactions simultaneously to its taxing authority and recovers the amount it paid in VAT to its suppliers. Thus, the only cost the manufacturer incurs is the VAT on the profit, or the difference between what it sells its product for and what it pays for the product's components.

When an industry or firm is exempt from VAT, consumers do not pay VAT on its products and services. In theory, the organization should pay tax on its inputs and charge tax on its value added. However, when the services are exempt, the institutions collect no tax from consumers and are therefore unable to recover the VAT that the institutions pay to their suppliers and service providers.

When an exempt institution acquires services, such as information technology services, from an outside company--one not affiliated with the institution--it must pay a VAT on those services. In contrast to the manufacturing example, where the company passes the VAT on to the end user of the service, the exempt institution cannot recover from its taxing authority or its customer the tax it paid to its information technology supplier. Thus, the institution must absorb the cost, reducing the flexibility it has in pricing its end products or services.

On the other hand, when an institution provides information technology services in-house to itself, it does not have to pay VAT. Thus, the cost of services in-

house is automatically less expensive by the percentage VAT that would normally be paid. Thus, a VAT-exempt entity would only acquire outside information technology services when the perceived value of obtaining those services externally exceeded the cost of in-house provision by the amount of the VAT.

## Alternatives

There are a number of possible solutions, all of which are meant to put the tax-exempt business in the same VAT position whether it outsourced the contract or undertook the contract in-house.

1. One option would be to shift the exemption from VAT further down the supply chain, so that the service provided by the outsourcer would be exempt from VAT. As the wage costs are within the outsourcer, this would ensure that these costs would not bear VAT and hence would provide parity between an in-house service and an outsourced service.

In practice, one way this could be achieved is through uniform application of the principles set out in the *Sparekassernes Data Centre ("SDC")* case. The SDC case concludes that, if a service is exempt from VAT, then it should be exempt from VAT whether provided by a financial institution or other supplier. Hence for some services to Businesses, the Outsourcer should be able to exempt the outsourcing fee from VAT.

However, this solution only resolves the limited subset of outsourcing contracts that are core to processing financial transactions. The VAT distortion would remain for the vast majority of outsourcing scenarios.

2. A more universal solution would be a widening of the VAT exemptions to encompass outsourced services provided to financial institutions.

Variants of this option include:

- Allowing exemption only where the Business provides predominantly exempt services.
  - Universal exemption (as above) subject to an option to tax.
3. A third option involves accepting that VAT will be charged on the contract but allowing the vat-exempt business to recover part of the VAT so that it again finds itself in a similar position as if it had undertaken the contract in-house.

The Australian Government chose this solution when introducing GST. The tax-exempt business is automatically entitled to reclaim from the tax authorities a fixed proportion of the VAT incurred on the outsourcing contract. The proportion to be recovered is set at an estimate of the labour element of the underlying contract – 75% was chosen in Australia. The balance is treated as input tax in accordance with the “normal” rules.

4. A fourth alternative is to leave the VAT provisions the same but alter the amount that the VAT provisions apply to. This involves disregarding the actual amount of the contract (95% in the above example) and replacing this with a value that would have been subject to VAT under the in-house scenario (25% in the above example).
5. A fifth option would involve designating outsourcing as a reduced rate service. By applying the reduced rate to the whole of the contract fee, the total VAT incurred would be closer to that undertaken in an in-house scenario.
6. A sixth alternative is to make the exempt enterprise partially exempt – so that only the (for example) core financial services are exempt. All other transactions are subject to VAT. So, whether it be purchasing of consumables or outsourcing the development and operation of IT, they pay (and can recover) VAT. In this example, banks do not charge VAT on interest, but they do charge VAT on checkbooks, transaction processing, documentation fees and the like.

## **Recommendation**

WITSA recommends that governments implement measures to introduce VAT parity for tax-exempt businesses to outsource their information technology services as a means of improving competitiveness and economic growth.