

# The Death of the Indirect Tax Return

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Historically, the relationship between the state and taxpayers has followed a certain social contract: The state imposes taxes, taxpayers self-assess these taxes, and the state verifies the accuracy of the self-assessments.<sup>1</sup> This approach has been practical, because taxpayers are in the best position to identify and report their tax-related activities (sales, purchases, withdrawals of inventories, fringe benefits, etc.) and self-assess the tax. Consequently, the tax return serves as a statement that defines the scope of each business's

<sup>1</sup>This is true for most general taxes, such as income taxes and indirect taxes, but does not apply when the state has a specific control function for other regulatory reasons (for example, for customs purposes, duties are generally assessed during customs clearance when officials verify the entrance of goods into the state).

and individual's tax liabilities while providing the state with the necessary information to perform verification.

However, the increasing complexity of national and international tax systems and advancements in technology are gradually changing this social contract. Now, the state is more likely to levy taxes, assess these taxes, and allow the taxpayer to perform post-assessment controls (if any). This shift has been most evident in the realm of indirect levies, particularly VAT systems. Over the past 20 years, and more prominently in the last five years, tax authorities have heavily invested in new tools and introduced continuous transaction control (CTC) mandates. CTC is a form of transaction-based reporting or clearance, either based on the actual invoice or a subset of the invoice.<sup>2</sup> CTCs enable tax authorities to collect data associated with business activities relevant for specific tax assessments, increasing efficiency and reducing tax evasion.

To fully comprehend this transformation, it is crucial to first understand why VAT systems are more prone to adopting these requirements. We discuss the rise of CTC mandates and the potential consequences for the future of indirect tax compliance, including the challenges and implications for businesses and taxpayers. Emphasizing the importance of understanding these changes is essential for businesses, tax professionals, and policymakers, because it underscores the relevance of the article's content and highlights the need for adaptation in the ever-evolving tax landscape.

<sup>2</sup>See, e.g., European E-Invoicing Service Providers Association, "Glossary – CTC (Continuous Transaction Controls)" (last accessed Nov. 20, 2023).

## Why Are VAT Systems Prone to Adopt CTCs?

### Understanding the VAT System

The VAT system, also known as goods and services tax in some countries, is widely recognized as an efficient consumption tax in terms of revenue generation for governments and neutrality toward domestic and international trade. Today, over 170 jurisdictions and 37 of the 38 OECD countries have implemented some form of VAT.<sup>3</sup> Because VAT is an indirect consumption tax, economic operators (vendors of goods and services) act as tax agents on behalf of the state, charging and collecting taxes applicable to the consumption of goods and services and subsequently remitting them to the state. Policymakers and economists generally acknowledge a VAT's capacity to raise revenue in a neutral and transparent manner, contributing to its virtually universal adoption.

The success of VAT systems stems from several advantages they have over single-stage consumption taxes like sales taxes adopted by U.S. states. Because VAT is collected at stages along the supply chain, rather than at a single stage, it is more secure for governments to collect taxes on each leg of the supply chain: If one part of the chain fails to collect taxes, the government's lost revenue will be limited to the markup at that stage. Moreover, in business-to-business transactions, the seller's payable VAT becomes deductible VAT for the purchaser. This self-enforcing nature of VAT discourages tax evasion, because businesses know that their trading counterparts will report their sales or purchases. Formal invoicing requirements in VAT systems create an auditable paper or electronic trail, and because of the invoice credit nature of the tax, transactions should appear on both the vendor's and purchaser's tax returns, providing better opportunities to detect evasion. Also, tax authorities can estimate a reasonable level of sales through the credit mechanism, which is particularly useful at the retail level in which there may not be a purchaser claiming a credit that would allow matching transactions.

<sup>3</sup> OECD, "Consumption Tax Trends 2020: VAT/GST and Excise Rates, Trends and Policy Issues, OECD Publishing," at 28 (Dec. 3, 2020).

## Weaknesses in the VAT System

The two benefits of VAT — taxation throughout the supply chain and the invoice-credit mechanism — also constitute its weakest points. Because economic operators handle taxes on behalf of the state, the multiple stages of taxation and the related credit mechanism open the system to potential attacks by noncompliant or fraudulent economic operators. Tax authorities must exercise control over all economic operators in the supply chain, rather than focusing on a limited population of tax filers (retailers to final consumers, or manufacturers and importers). Moreover, because the invoice is a pillar of the VAT credit mechanism, the government's final tax collection becomes entirely dependent on the deductions claimed by taxpayers. This vulnerability exposes the system to taxpayers who declare creditable purchases falsely or use false or altered invoices to claim credits that reduce their tax liabilities.

In Europe, these weaknesses have been exploited by fraudulent operators performing so-called missing trader fraud schemes in which a trader charges and collects VAT from customers but does not remit it to the state before disappearing.<sup>4</sup> In Latin America, VAT systems have been abused by "invoice manufacturers" that produce legally generated invoices that are sold to businesses to reduce their tax liabilities by increasing their expenses for income taxes and creating credits for VAT.<sup>5</sup> Another widespread fraud scheme involves the use of automated sales suppression devices (also known as zappers) that falsify the electronic records of point-of-sale systems (for example, reporting only nine of every 10 sales).

These weaknesses not only result in revenue losses for the state, but also affect businesses and consumers. For instance, the EU estimates that the VAT gap (the difference between expected revenues in EU member states and the revenues collected) for all 27 EU member states was €134

<sup>4</sup> European Parliament, "Missing Trader Intra-Community Fraud" (June 2021).

<sup>5</sup> Well known in Mexico is *Empresas Factureras*, a case regarding a business dedicated to creating invoices supporting fake transactions. The tax administration regularly publishes a list of businesses that are presumed to produce this kind of invoice.

billion in 2019.<sup>6</sup> This lost revenue may result in increased tax rates or reduced public services, ultimately harming both businesses and consumers.

### Weaknesses in VAT and the Role of Technology

Despite generating more tax revenue than corporate income taxes,<sup>7</sup> most tax authorities have historically focused VAT compliance checks on the largest economic operators and business sectors with higher perceived risks of noncompliance (for example, construction, retail, etc.). This minimal approach can be attributed to the fact that reviewing the accuracy of VAT returns would require a large number of tax inspectors that no country could afford. Indeed, the details in VAT returns vary by country, with some countries limiting the information disclosed to the sum of output and input tax, while others require a more detailed listing of transactions performed (e.g., domestic sales vs. exports, goods vs. services, taxable vs. exempt). Regardless of the level of detail, most errors are hidden in the line items of the VAT return working papers, which, depending on the size and complexity of the business, could include a significant amount of data. Therefore, without proper tools, identifying any inaccuracies could be akin to finding a needle in a haystack.

Recently, technological advancements have provided tax authorities with new tools to identify inaccuracies in VAT returns more efficiently.<sup>8</sup> For example, data analytics and artificial intelligence can help tax authorities analyze large volumes of data and identify patterns indicative of fraud or noncompliance. These technological tools have begun to reshape the landscape of VAT administration, leading to the rise of CTC mandates.

<sup>6</sup> See, e.g., European Commission, “Taxation and Customs Union – VAT Gap” (last accessed Nov. 20, 2023).

<sup>7</sup> According to the OECD, 21 percent of tax revenues OECD-wide in 2019 were from general consumption taxes, such as VAT, and only 10 percent from corporate income taxes. OECD, Global Revenue Statistics Database.

<sup>8</sup> Inter-American Center of Tax Administrations, “Artificial Intelligence Applied to Auditing” (Oct. 13, 2020).

### The Rise of CTC Mandates

The vulnerabilities in the VAT system and its administration, coupled with the emergence of modern technological tools and tighter budget constraints over the past 15 years, have prompted a fundamental reassessment of how VAT compliance and administration ought to be managed. Over 30 countries globally have implemented or are in the process of introducing some form of CTC mandate. Essentially, these mandates require taxpayers to notify the tax administration in real time or nearly real time of each sales transaction (and often purchases as well) that they conduct. To achieve this, CTC mandates use technology to convert the paper invoice into a government-regulated e-invoice system and modernize the data reported by economic operators.

### Overview of CTC Mandates

Because of the absence of harmonization and the distinctiveness of each country’s historical tax compliance system, various CTC models have emerged, all converging toward the same objectives.

#### Clearance Model

This model mandates that issuers of e-invoices obtain authorization from the tax authority before submitting those invoices to their business counterparts. Under this model, the tax authority must validate invoices, record them in its system, and assign a unique ID number or digital seal that confirms their validity. Only after the invoice is cleared does it become a legal document for all tax purposes. This system is prevalent in Latin America and other regions worldwide.<sup>9</sup>

#### Real-Time Reporting Model

In this CTC mandate model, taxpayers must report a complete invoice or a subset of it at the same time it is issued to the client. Under these systems, the tax administration does not pre-validate the invoices, but if an invoice is rejected by the tax authority for any reason, the

<sup>9</sup> This is the trending pre-clearance system used in countries like Brazil, Italy, and Turkey, just to name a few.



issuer will be required to produce a new invoice and notify the client.<sup>10</sup>

### Post-Clearance Model

Under this system, e-invoices are not required to be pre-authorized by the tax authority. Instead, the taxpayer is mandated to submit the invoices issued to their clients within a specific period (usually one to four days).<sup>11</sup>

### Centralized Model

Under this system, the tax authorities create a single infrastructure for communicating invoices to be used by all taxpayers to communicate with the authority and their counterparts. France and Italy employ this system. Invoices transmitted outside of the system do not have any tax validity and can be subject to penalties by tax authorities.

### Interoperability

Most experts concur that this is not a CTC model of e-invoicing per se because it does not require the direct intervention of the tax administration or the existence of a tax mandate. But tax administrations benefit from the flow of invoice information between sellers and buyers and typically construct the e-invoicing system on that infrastructure. The PEPPOL (Pan-European Public Procurement Online) system exemplifies this invoicing model.

Moreover, tax administrations also benefit from the flow of invoice information between sellers and buyers, because it contributes to more efficient tax compliance and reporting. By having access to real-time data, tax authorities can quickly identify discrepancies and potential fraud, leading to increased revenue collection and streamlined tax administration processes.

### Evolution of CTC Mandates

The primary purpose of an e-invoicing mandate is to capture sales and purchase information from the data included on the invoices issued. However, that is usually only the beginning. The need to control transactions to ensure tax compliance is not limited to sales and

purchases. It extends to other activities that have a direct effect on the compliance of the taxpayers, such as the distribution of goods, payments, and other transactions that traditionally have not been supported by an invoice. Once the e-invoicing infrastructure is established, it has proven very successful for controlling other activities of the taxpayers, such as payroll, healthcare payments, movement of products between companies, and control of inventory as a result of the movement of products within businesses. One of the reasons for the growing popularity and adoption of CTC mandates is their adaptability. They can be tailored to the needs and requirements of individual countries, industries, or types of transactions, allowing for a more targeted approach to tax compliance and enforcement.

Regardless of the CTC model adopted by the country, governments have expanded and refined these e-invoicing and digital reporting mandates, focusing on the quantity, quality, and speed of the information extracted.

### Quantity

In terms of quantity, a typical e-invoicing mandate requires taxpayers to provide more data than the traditional information included on paper invoices. For instance, a typical Mexican e-invoice (*comprobantes fiscal digital por internet*, or CFDI) provides the tax authority, in addition to standard invoicing content, information about the means of payment used (cash, check, credit card); whether the payment made was in full, in installments, or on credit; the tax regime; the currency used; the exchange rate if applicable; the type of CFDI; the destination of the sale; the place of issuance of the CFDI; previous invoices related to the CFDI; the classification code of the goods or services invoiced; an invoice authorization number provided by the Mexican tax authority; and even the use that the recipient will give to the invoice.

### Quality

Business transactions are very different from one another, and tax policymakers know that applying a one-size-fits-all list of mandatory invoice information requirements would not work. For instance, the tax-relevant information needed for an invoice generated by a supplier of hauling and delivery services is very different from that of an invoice generated for the supply of

<sup>10</sup>This approach is used in Costa Rica and Ecuador.

<sup>11</sup>This system is used in South Korea, Spain with the immediate supply of information mandate, and all countries requiring a Standard Auto File for Tax report.

fuels. By focusing on certain types of information that vary based on the type of transaction carried out, the authority can perform some types of validations that allow it to make more accurate and qualitative evaluations of the taxpayer's compliance.

As a result, there is a clear trend to impose the use of specialized invoices or annexes to invoices, depending on the parties involved or the transactions carried out. Mexico, to keep with the previous example, already has around 30 different supplements (locally known as *complementos*) to the CFDI that provide the tax authority with additional information depending on the transaction performed (for example, leasing or sales of shares) or the parties involved (for example, digital platforms or payments to foreigners).

In Colombia, healthcare providers are required to use the e-invoice for the healthcare sector (*factura electronica del sector salud*), which includes not only billing data but also relevant healthcare data. Other countries that seem to have a single electronic schema for their e-invoices have many fields that shift from optional to mandatory as soon as certain transactions or parties are indicated. The tax authorities have decided to implement this type of invoice because the e-invoicing platform can be used to supply relevant data to other authorities, such as the healthcare ministry and insurance board of the government.

Regardless of the method used by the tax authorities to gather taxpayer information, the result is that these CTC mandates put them in a position to know with a high level of precision how the tax obligations of the parties involved will look by the end of the period, based on the timing, scope, and nature of the transactions.

### Timing and Format

Keep in mind that under most CTC mandates, sales data hit the tax administration servers before they get to the hands of the recipient of the invoice (pre-clearance systems), or shortly after that (post-clearance systems). In Spain, for instance, the immediate supply of information system requires taxpayers to submit sales and purchase invoice information to the Spanish tax authority within four days of issuing the invoice for sales or receiving the invoice for purchases. However, the

tax authority will soon be receiving that invoice information in real time once the general e-invoicing mandate starts to be deployed soon.

Countries that are more lenient in terms of time for remittance, such as those with Standard Auto File for Tax requirements (Poland, Portugal, Romania, and others), can wait until the end of the month to receive that data. But they are becoming fewer and fewer because most of them are migrating toward the application of real-time e-invoicing mandates.

Whether invoicing information is expected in real time, or on a daily, weekly, or monthly basis, all these countries require the information to be provided in machine-readable language (mostly XML or JSON formats) that allows tax authorities to validate the accuracy of the data in record time. In some cases in which the tax administration is the sole administrator of the invoicing system, failure to execute the validation of the documents sent by the taxpayers has created serious inconveniences. The authorities usually solve or try to neutralize the effects of these shortcomings by allowing third parties to validate taxpayers' electronic invoices. In other situations, authorities allow taxpayers to use contingency paper invoices until the system is back up and running.

Businesses may face potential challenges in adapting to the various reporting timelines and formats required by different CTC mandates. These challenges could include the need for new technology or software, staff training, and potential penalties for noncompliance. It is crucial for businesses to stay informed about the evolving requirements and invest in the necessary resources to ensure compliance.

### Benefits and Challenges of CTC Mandates

The implementation of CTC mandates brings several benefits to both tax administrations and taxpayers. One of the main advantages is improved tax compliance, because real-time or near-real-time reporting of transactions allows tax authorities to identify and address noncompliance issues more effectively, reducing tax fraud and evasion. Another benefit is increased efficiency, because e-invoicing and digital reporting, in theory, reduce the administrative burden on businesses, eliminating the need to manually prepare and submit paper

invoices. This can lead to cost savings and increased productivity. Further, e-invoicing systems aim at enhancing data quality by improving the accuracy and consistency of the reported data, reducing the risk of errors and discrepancies. Last, real-time reporting enables businesses to have a better understanding of their tax liabilities, allowing them to manage their cash flow more effectively.

Despite the benefits, there are also some challenges associated with CTC mandates. One is technology barriers because the adoption of e-invoicing and digital reporting systems requires significant investments in technology and infrastructure. Smaller businesses may struggle to afford the necessary upgrades, and even larger companies may face challenges in integrating new systems with their existing processes. Another challenge is data privacy and security concerns raised by the transmission of sensitive financial data through electronic systems. Tax administrations and businesses must ensure that they have robust security measures in place to protect against data breaches and cyberattacks. Last, regulatory complexity can pose a challenge because the lack of harmonization in CTC mandates across different countries can create confusion and compliance challenges for businesses operating in multiple jurisdictions. Companies must stay up to date with the latest regulatory changes and ensure that their systems can accommodate different reporting requirements.

## The Future of Indirect Tax Compliance

### The Future of the VAT Return

As more transactional data flow into tax administrations because of the adoption of CTC mandates, it becomes possible to pre-fill tax returns. This not only ensures accurate compliance but also reduces costs of taxpayer compliance and tax administration.<sup>12</sup> The OECD's Forum on Tax Administration has identified pre-filled tax returns as a primary goal for tax administrations

<sup>12</sup> Intra-European Organization of Tax Administrations, "Pre-Filled and Electronic Income Tax Returns" (2008).

implementing CTC mandates.<sup>13</sup> In this regard, pre-filled VAT returns are not a sci-fi fantasy but a reality that is already happening in a jurisdiction near you and is likely going to spread like a bush fire over the next several years.

In 2020 the European Commission proposed implementing pre-filled VAT returns as part of a larger policy document.<sup>14</sup> Since then, EU member states have been actively working on this initiative. For example, Spain introduced the Pre-303 in 2021, providing taxpayers with a pre-filled VAT return based on the information obtained from the sales and purchase ledgers that are part of the immediate supply of information mandate. Italy, Hungary, Portugal,<sup>15</sup> and Greece have also made progress in this area.<sup>16</sup>

Outside the EU, Latin America has been advancing in pre-filling taxpayers' VAT returns. Chile is a leading jurisdiction in this effort, with its tax authority providing complete or partial pre-filled VAT returns (*Propuesta de IVA*)<sup>17</sup> based on the e-invoices processed during the filing period. Mexico, Ecuador, and Peru have also made strides in implementing similar systems.<sup>18</sup> In the Asia-Pacific region, countries like South Korea and India are using CTC mandates to pre-fill VAT returns for certain groups of taxpayers.<sup>19</sup>

Despite these advancements, traditional VAT returns will not disappear entirely soon. Tax administrations recognize that taxpayers may be skeptical of pre-filled tax returns and that there may be risks associated with relying solely on the data collected by tax authorities. For now, pre-filled VAT returns are being presented as a

<sup>13</sup> OECD, "Tax Administration 3.0 and Electronic Invoicing: Initial Findings" (Sept. 28, 2022).

<sup>14</sup> European Commission, "Communication From the Commission to the European Parliament and the Council: An Action Plan for Fair and Simple Taxation Supporting the Recovery Strategy," COM(2020) 312 final (July 15, 2020).

<sup>15</sup> AT Autoridade Tributária e Aduaneira, "IVA Automático +: pré-preenchimento das declarações periódicas de IVA" (last accessed Nov. 21, 2023) (in Portuguese).

<sup>16</sup> Greece announced the process of pre-filling the VAT returns of taxpayers in November 2022 (in Greek).

<sup>17</sup> Servicio de Impuestos Internos, "La Propuesta de Declaración de IVA te simplificará la vida" (last accessed Nov. 21, 2023) (in Spanish).

<sup>18</sup> Gobierno de México, "Presenta tu declaración de pagos provisionales y definitivos. Régimen simplificado de confianza" (2023) (in Spanish).

<sup>19</sup> Asian Development Bank, "A Comparative Analysis of Tax Administrations in Asia and the Pacific" (2020).

tool to facilitate compliance and reduce the cost of fulfilling tax obligations, rather than as a mandated replacement for traditional VAT returns.

### The Transformation of Tax Departments

CTC mandates have a significant effect on businesses, particularly on their IT departments, because they require large investments and continuous monitoring and updating in response to changing CTC systems. However, the effects of these mandates extend beyond IT departments, affecting accounts receivable, accounts payable, and day-to-day operations as businesses adapt to new compliance requirements and processes.

Tax departments will also undergo significant transformations because professionals must understand not only tax laws but also how to translate these laws into IT technical specifications. This creates new challenges for tax professionals as they navigate the often complex and nuanced world of tax laws and adapt them to the binary nature of IT systems. As a result, tax professionals will need to acquire new skills and knowledge in areas such as data analysis, IT systems, and cybersecurity. The need for ongoing professional development and training will become increasingly important in this evolving landscape.

### Replacing VAT With Technology-Driven Sales Tax

As tax authorities gain more information from CTC mandates, the question arises whether a VAT system is still preferable to a sales tax. A well-designed CTC mandate involving “trusted taxpayers” could lead to a single-level sales tax imposed on end customers. This transformation would reduce tax obligations for most businesses while maintaining the same revenue for the government.

By becoming CTC compliant, businesses would gain VAT cash flow savings, as they would no longer need to collect and remit VAT on behalf of the government, claim credits, or request refunds. Also, tax administration would be simplified because tax authorities would only need to focus on end-sales and ensuring that businesses in the middle of the supply chain

remain compliant with CTC mandates to qualify as “trusted taxpayers.”

CTC systems also challenge the traditional VAT paradigm of collecting VAT on an accrual basis. As tax administrations gain real-time information on invoicing and payments, it may be more appropriate to collect tax based on payments received rather than values invoiced. This is especially true if the tax is transformed into a single-stage technology-driven sales tax applicable to end customers, because invoice and payment times are often aligned for these transactions.

### Conclusion

The adoption of CTC mandates will significantly alter the landscape of indirect tax compliance. The rise of CTC mandates, driven by technological advancements and the need for improved tax compliance, should lead to increased efficiency and enhanced data quality. With the increasing amount of data that CTC systems provide to tax authorities, taxpayers will shift their obligations from declaring to reconciling data. In that sense, we are witnessing the dawn of the end of the tax return. These mandates pose further challenges, such as technological barriers, data privacy concerns, and regulatory complexity. The technological evolution may also lead to more fundamental changes because emerging technologies, such as blockchain, artificial intelligence, and machine learning, could further enhance the effectiveness and efficiency of CTC mandates and perhaps lead to the proposed technology-driven sales tax system.

It is essential for businesses, tax professionals, and policymakers to stay informed about these changes and adapt to the evolving tax landscape. By understanding the implications of CTC mandates and embracing the opportunities they present, stakeholders can navigate the challenges



and capitalize on the benefits of a more efficient and effective tax system.<sup>20</sup> ■

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