

Indirect taxes come out of the shadows

INDIRECT TAXES

As company profits fall and direct tax receipts plummet, tax authorities will start looking to indirect taxes to generate revenue. **Joanna Faith** finds out what tax departments should be doing to prepare for this shift in focus.

Four years ago, electronics and entertainment company Sony hired its first strategic VAT director. Before Lynne Clare's arrival Sony viewed VAT as purely a compliance issue with people embedded in various parts of the company dealing with it. Since her arrival, however, there has been a change in perspective.

"The company realised they could only ignore VAT for so long," Clare says. "One colleague even told me she didn't know how they'd coped without me."

As her job title suggests, Clare's role is strategic which means she has to know how the business runs. She admits this is something direct tax leaders tend to ignore. Her role is to ensure Sony complies with its requirements around the world in an efficient fashion, to make sure that contracts

do not disadvantage the company from a VAT perspective and to guarantee it is recovering all the VAT it is entitled to recover.

More and more multinational enterprises are hiring indirect tax specialists. But they are still the minority.

"In a typical corporate tax department there are 12 people managing what is often a nil rate of corporate income tax but only one person handling the VAT position which can amount to millions of dollars," says Chris Walsh, chief international indirect tax officer at Vertex, a technology provider, and a one-time indirect tax practitioner. "There's a big imbalance."

This imbalance will soon become more conspicuous. Tax professionals predict that as the economic downturn continues, the authorities will turn their attention to indirect taxes to fill the black hole in public

finances. With direct tax receipts plummeting, they will have no other choice.

Even though indirect taxes are becoming more and more important for national tax authorities, none would comment on the record for this article. They claimed it was a policy issue.

The shift in focus to indirect taxes is not just a result of troubled economic times. Competition for tax revenue, cuts in direct tax rates around the world and increasingly complex business structures all mean tax directors need to pay more attention to indirect taxes.

An extra ingredient in the change of focus is the actual and potential establishment of national indirect tax systems in countries that have never had them before, such as India and the US, and reform of VAT rules in the EU.

Cash is king

For some companies, especially those in the financial services sector, indirect taxes will be the only taxes they pay for the foreseeable future. "Your bottom line could be red but you'd still need to pay VAT," says Laurent Grençon, a partner at Atoz in Luxembourg.

This will mean a shift from the norm for most companies. Tax teams consist largely of direct tax professionals and the tax director, who has a direct tax background, is not incentivised to manage the indirect tax burden.

"Heads of tax are measured by the effective tax rate," says Gary Harley, an indirect tax partner at KPMG in London. "Most organisations just see indirect taxes as a compliance issue," he says.

"Until tax directors are measured on how they manage global taxes, not much will change," says Walsh.

Awareness of the importance of indirect taxes is starting to hit companies. "I had a meeting with a CFO recently who wanted to know of ways to work on French business tax and VAT as these were his only costs at the moment," says Benjamin Homo from Mayer Brown in Paris. "These days I'm getting more calls from clients on indirect taxes than I was this time last year."

Financial troubles coupled with the introduction of corporate governance and accounting standards such as Sarbanes-Oxley and FIN 48 has changed the shape of the in-house tax department. Aggressive planning structures are a rarity. Many companies are using losses.

"This leaves people asking what will happen to huge corporate tax departments," says the head of VAT at an international bank. "One obvious option is moving staff onto indirect tax projects."

The economic downturn is a good opportunity for tax directors to concentrate on indirect taxes. "Pre credit crunch, tax departments were involved in transactions, acquisitions and restructurings," says Stephen Coleclough from PricewaterhouseCoopers in the UK. "These were taking up most of the tax director's time. Now there are no transactions to occupy them," he says.

Companies are desperate for cash. Management is piling on pressure for all departments to improve cash flow and tax departments are turning to indirect taxes to deliver. "There's a lot they can do with indirect taxes," says Homo, "not just with reducing the amounts but a lot to do with the timing of payments."

Suppliers can use instalment systems which means they do not have to collect VAT until the final payment is made, Homo says. "It may sound like a small thing but it

CASE STUDIES	
Real estate	Companies in the real estate sector could be affected by EU adjustment rules. At the beginning of the use of a building, a taxpayer can recover VAT on construction costs. As a matter of example, if the tenant goes bankrupt and the building is vacant, the tax authorities can ask the real estate company to repay the VAT that was initially deducted. This could be an extra cost and could cause big cash flow issues for companies.
Distressed sales	In unusual contractual arrangements, a taxpayer may find VAT charges you were not expecting. If a business is badly run or is functioning badly, it may pay someone to take it off its hands. The unusual situation of payment by seller to buyer could be subject to VAT. Advisers would structure the deal to get around this problem.

could be a big cash saving opportunity."

"Simple things can generate cash quickly," says Harley. "Most companies don't have harmonised systems across all their international markets. They might have the numbers right in their home country but that's the easy bit," he says.

Ahead of the game

Companies need to be prepared for tax administrations taking a harder line when it comes to indirect taxes.

"Tax authorities are getting more aggressive regarding indirect tax arrangements," Harley says.

Iain Shore, group indirect tax manager at Taylor Wimpey, a homebuilding company, says the UK authorities have not started concentrating on indirect taxes yet. "But they would be really incompetent if they didn't start soon," he says.

A report published last autumn by KPMG issued a similar warning.

"As corporate tax rates fall worldwide and corporations become more fleet of foot in relocating to favourable jurisdictions, national governments can no longer rely on corporate tax receipts. But they still need to collect revenues and they are looking towards indirect taxes to do this," said Sue Bonney from KPMG, at the time the report was published.

"For several years there have been signs that governments throughout the world have been switching their attention to indirect taxes, but this year that trend has become much clearer," the report says.

The shift in focus towards indirect taxes highlights the benefit of an in-house indirect tax specialist.

"A good VAT manager could be a definite advantage," says Chris Harrison from the law firm Allen & Overy.

A dedicated resource in-house can keep on top of tribunal cases or changes to EU law, which could significantly disadvantage a company's cash flow if they were overlooked.

The Condé Nast and Michael Fleming case in the UK, where the taxpayer defeated the tax authorities over repayments of

overpaid tax, is an example. Companies had until the end of March this year to claim refunds.

"The board was very interested in Condé Nast," says Shore.

A lot of companies are ploughing resources into this matter. The UK Revenue underestimated the cost of Condé Nast significantly says the head of VAT at a major international bank. "We had enquiries a only few months ago from the tax authorities asking how much we expected our claims to amount to," he says.

Returning proceeds from indirect taxes is on the French government's agenda too, however the plan may not last. They have issued a directive allowing taxpayers to receive VAT refunds quicker, leading to significant cash improvements for many companies during the unstable economic period. Companies can now ask the tax administration for refunds on a monthly basis rather than every quarter.

"This is part of the government's plan to jump-start the economy," says Homo. "But it won't be their long-term strategy." He predicts the revenue authorities will go back to investigate these refunds in more detail in a few months time to make sure they got it right and that companies' accounts were in order. "Auditors will start spending weeks on indirect taxes if there are no direct taxes," he says.

And China has looked to export VAT refund rates to stimulate its economy. In the past, the country continually adjusted the rates of goods exported from China and reduced them significantly. But in response to the global economic difficulties and sharply decreasing exports, China has increased VAT refund rates for certain products.

"With new rules announced to streamline the export VAT refund process, companies should be able to receive refunds in a timely manner or should consider escalating the issue to improve cash flow," says Robert Smith from Ernst & Young in China.

New systems

The focus on indirect taxes is not just a result of the global recession. It is a much

longer term trend. "It probably started in the mid to late 90s when people realised it was an important part of the cost base that needed managing," says the head of VAT at an international bank. "There has been a temporary spike thanks to the economic crisis but it is still an upward curve," he adds.

Governments grasped the importance of indirect taxes well before the financial crisis began.

Countries on all continents have been implementing new indirect tax systems. "If you look back 20 years only Europe and a few places outside of Europe had VAT systems," says Mark Delaney from Baker & McKenzie in the UK.

There are more systems in Latin America, Asia Pacific and Central America. Australia introduced a GST system in 2000 and in Africa a large proportion of states have VAT rules. The UAE is planning to implement a GST/VAT system; although the proposals have reportedly been put on hold because of the political and economic concerns. And as the EU has expanded so has the number of VAT regimes.

Talk of further new set-ups around the world has been circulating for years. In India for example, there has been a move towards a goods and services tax since 2005. All 29 states have so far aligned their tax on goods but not on services. The country has a provisional date of April 1 2010 for a unified VAT system to be implemented.

"This will be the most important tax initiative post independence," says Rajeev Dimri from BMR Advisors in India.

"Because 2010 is just around the corner CFOs must start paying attention to it. The new system may allow changes to relocation strategies," he says.

With the introduction of a new indirect tax system in India, multinationals need to remain vigilant not just for the next year or two but for three or four years, Dimri warns. "Everything will remain fluid and businesses will have to learn to adapt," he says.

A VAT system to replace its states' sales tax scheme is also a possible option in the US which would have an impact on companies globally.

"I'd never say never to a VAT system in the US," says Gary LeDonne Americas director of indirect tax at Ernst & Young. "The Bush administration discussed it a few years back. But it would be a big adjustment for the country and put a lot of strain on companies. In the long run it may be a good thing but in the short run there would be big compliance issues."

Coleclough is more forthright. He thinks there will be a VAT system in the US in 10 years. "Ignoring the current economic crisis,

Examples of indirect taxes

VAT
GST
Sales taxes
Service tax
Business tax
Customs duties
Excises
Energy taxes
Environmental taxes
Insurance premium tax

it's a more global economy and the US government will need to look domestically in the face of global competition for tax revenues," he says.

On top of new and potential systems, tax directors also need to be aware of changing legislation. On January 1 2010, the EU will amend its VAT system regarding the rules on the place of supply of services and recovery of the tax incurred in other EU member states.

Rules are becoming more complicated to match globalisation and the increasing sophistication of business structures. Changes need to be monitored internally to make sure the correct amount of VAT is being paid or reclaimed.

"The EU system is complex and difficult to interpret," says Delaney, "and the complexity of VAT systems is hurting business. The biggest problem is inconsistency," he adds. "The OECD has talked about a model VAT system but it's not going to happen, not with all the exemptions, reliefs and rates in the EU."

The European Commission has proposed simplifying, modernising and harmonising VAT invoicing rules in an attempt to combat VAT fraud. They hope it will enable more companies to use e-invoicing.

And the Commission and business is continuing to discuss which financial services should be exempt and which should be taxable. European Union officials want to redefine the barriers but it is nowhere near a conclusion, says the head of VAT at an international bank.

Competition is hot

The KPMG survey found that while corporate tax rates have been falling worldwide, indirect tax rates have remained relatively stable, suggesting that if indirect tax yields are compensating for declining corporate tax yields, this is being achieved in other ways – , that is, a widening of the indirect tax base and a stricter application of the rules.

"More and more governments are introducing indirect tax systems and there is also a steady expansion of the transactions that these taxes are applied to, and a new focus

A selection of indirect tax rates (GST/VAT/consumption tax)

Argentina – 21%
Australia – 10%
Belgium – 21%
Chile – 19%
China – 5%
Denmark – 25%
Hungary – 20%
Iceland – 24.5%
Ireland – 21.5%
Israel – 15.5%
Japan – 5%
New Zealand – 12.5%
Philippines – 12%
South Korea – 10%
Singapore – 7%

from tax authorities on efficient collection of indirect taxes through corporate tax departments," Bonney said when the report was issued.

One head of VAT at an international bank thinks indirect tax rates will go up. "The VAT rate in the UK will probably increase to above what it was before last year's decrease," he says.

Higher rates is not a new trend. In 2007, Germany's VAT rate went from 16% to 19%. Sweden's rate is as high as it can go – 25%. Even if rates remain static, bases are likely to be widened, the VAT director says.

Indirect tax rates had a significant impact on companies' cash flow before the recession. And they will continue to do so in brighter economic times. Companies cannot afford to be left behind as the focus shifts. This will mean a change in mindset for tax directors.

"VAT is a roll your sleeves up tax. It requires a different approach to corporate income tax," says Delaney.

It is up to heads of tax and company directors to change perspective and make sure indirect taxes have a beneficial impact on the business, not just during the downturn but in years to come.

Sony seems to have got it right. Through her guidance, Clare says her colleagues around the world are starting to see the importance of indirect taxes. In Japan, where they have a low consumption tax, she says they were sceptical about the importance of VAT. But this quickly changed when they realised how much money was being wasted through VAT incurred in Europe.

"Somebody told me they think all tax directors will soon be VAT specialists," Clare says. She doubts this will be the case but the fact people are starting to contemplate it signals an important change in mentality and in the future tax environment.