



THE CHANGING FACE OF VAT
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EXECUTIVE SUMMARY

Did you know that more than 120 countries around the world employ a Value Added Tax (VAT) or VAT-derived system as their primary method of levying consumption taxes? Over the years it has become almost impossible for a U.S. multinational company to operate without being impacted by this taxation.

Currently, the United States is the only significant economy in the world that does not utilize a VAT-type regime, so the concepts and processes involved in managing and controlling this tax are somewhat foreign and it is often considered that these tasks are best handled by local subsidiaries. This thinking is quite understandable, as VAT is a notoriously complex tax and it commonly has draconian penalties attached to getting it wrong. Additionally, as VAT is generally considered a “wash-through” tax, it tends to assume a lower priority in the minds of senior management, who consider it no more than a cash flow issue. However, consider this:

- On average, the global rate of VAT is around 18% and this rate of tax applies to both sales and purchases made overseas.
- Even excluding items not subject to this tax, it is common for VAT to represent 20-30% of a multinational’s overseas total cash flow (i.e. the sum of all inflows and outflows of cash in overseas operations).

With those points in mind, it should be expected that, if a U.S. multinational’s overseas subsidiaries have net revenues of \$20 million per annum, they are likely to have a total VAT cash flow in the order of \$5-6 million per annum. If annual overseas revenues are \$100 million, then a total VAT cash flow of \$25-30 million should be anticipated. Furthermore, for companies involved in making overseas supplies of financial or insurance services, healthcare, education, and/or real estate, VAT does not wash through the business’s records and generally represents an additional tax cost. Due to the high rates that apply, VAT often has a far greater impact on these types of businesses than any other tax.

Despite the fact that VAT can and does have such a significant impact on U.S. multinationals’ overseas businesses, most fail to do anything about it in terms of taking central management control of the position. Many U.S. accounting systems don’t even recognize VAT as a separate item, leaving it virtually invisible to finance managers. Next time you talk to your finance/accounting staff, ask them how much VAT is paid each year globally and how much VAT passes through the books of your overseas subsidiaries in respect of both purchases and sales. You can bet your bottom dollar that they will not be able to tell you. This, in itself, is a serious knowledge gap and should be a cause for concern, particularly for any CEO or CFO who might be called upon to attest to the company’s internal controls at year-end.

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BUSINESS EVENTS THAT IMPACT VAT

Some U.S. multinationals believe that their sophisticated Enterprise Resource Planning (ERP) systems are able to provide answers to the VAT problems. Unfortunately, this belief rarely has any basis in fact, even though such systems have varying degrees of native VAT functionality. When an ERP system is initially implemented, its VAT tables are populated with (hopefully) the correct rates of VAT that apply to the company's particular products and services. However, the system relies upon manual intervention for updating each time a VAT rate changes; or a new product or service is introduced; or the VAT rules change; or a new country market is being supplied. Further, the native functionality of ERP systems is not sufficiently comprehensive to handle many of the more complex transaction processes, in part because these systems were originally designed to cope with flows of goods and are not quite as strong when handling services, which can often be more complex in their structure. This means that somebody needs to be actively managing the VAT functionality to ensure the system's ability to achieve VAT compliance. In reality, this responsibility is usually passed to a staff member with little or no particular VAT expertise and who has neither the inclination nor the resources to keep track of the plethora of legislative and business changes occurring in several territories. The result is that, in short order, the data tables contained within the ERP system become out-of-date and unreliable.

However, it is not only the day-to-day business and legislative changes that impact a company's VAT position. Every business experiences certain key, one-off or occasional events in its life when it becomes essential to reexamine its entire VAT position because something fundamental is changing. The changes in question tend most often to be of the business's own making, such as with a merger or acquisition activity, the implementation of new accounting systems, an entry into a new market or a restructuring of the business model. On the other hand, the changes may be imposed upon the company through external factors, such as tax rule amendments or global economic conditions, which may force a revision of the company's cost structure. But why and how do these events affect a company's VAT position at such a basic level?

The simple answer is that anything that impacts a company's overseas supply chain will also impact its VAT profile, as the two are almost inseparable in an international context. The remaining pages of this white paper will provide you with an insight into how VAT affects an international business when a selection of key business events occur, such as:

INTERNATIONAL MERGERS AND ACQUISITIONS

Few events are more disruptive to a business than to be involved in a merger or acquisition activity and the ensuing post-deal reorganization processes. Apart from all the uncertainties that inevitably surround an event of this nature, the attention of the company's tax and finance staff tends to be drawn away from their normal focus in order to address integration issues. This diversion always occurs at a critical time because, in contrast to corporate income tax obligations (which generally arise on an annual basis), VAT filings are normally made monthly or quarterly. Therefore, any delay in addressing the group's new VAT profile can result in late filing, mis-declaration or late payment penalties and a poor compliance history from the inception of the new group.

One of the most common reasons why a company undertakes international M&A activities in the first place is to quickly expand into geographic areas where it does not already have a strong presence. However, from a VAT perspective, it means that the business is moving into new tax jurisdictions of which it may have little or no experience. Whilst this may not be an operational problem if the



company retains appropriate tax accounting staff from the target company, this does nothing to assist in the central management of the group's global VAT compliance position. Also, with the fact that the acquirer and the acquired will often be running different accounting systems, the co-ordination of the overall tax position becomes more complex at a time when the attention of the group's tax managers is focused elsewhere. Almost invariably, it is the group's VAT and tax compliance positions that take a back seat while the integration process moves ahead.

The knock-on effects of a merger often include a restructuring of the entire organization and the convergence of two or more accounting systems, as management seeks cost efficiencies to off-set or justify the acquisition costs and these types of activity impact the company's VAT position. For example, one of the most common post-deal activities that companies undertake is to streamline supply chains, leveraging their new buying power and limiting supplier numbers in the process. This may mean that materials that were previously delivered locally are now to be delivered internationally (or vice versa), so VAT can become a factor in the equation where it did not previously apply. However, supply chain project teams often do not consider these matters in their deliberations over new structures, so leaving their businesses with hidden tax exposures. Some of the other more common restructuring strategies and their VAT effects are considered below.

OUTSOURCING

There has been a trend in recent years to outsource non-core functions of the business. It should be remembered, however, that when a function is carried out in-house, there is little or no VAT consequence, as employee wages and benefits do not generally attract any VAT charge. Once the function is outsourced to a third party (including an associated business), suddenly VAT may be incurred on the costs of carrying out that same function. If the business is not able to reclaim its VAT in full, this will represent an additional cost and needs to be factored into the budget and decision-making process. Even if the company is able to reclaim its VAT, the move to outsourcing may significantly increase the amounts of VAT passed through its hands, making cash flow management and controls all the more important.

TOLL MANUFACTURING

Under a toll manufacturing arrangement, a third party manufacturer is engaged to make or assemble the principal's products. The principal pays a "toll fee" for each item produced. Commonly, the raw materials used in manufacture remain under the title of the principal throughout the process and the toll manufacturer provides only production services. The VAT problem is that the tolling company may be in a different territory from the principal, which means that the principal has ownership of goods in a foreign country. Whether they sell those goods within that country or they export them elsewhere, they become taxable people in the overseas location, thus triggering all the compliance and filing liabilities that go with that.

The most extreme example of this that I have come across concerned a pharmaceutical company that was based in Switzerland. It provided raw materials for the manufacture of its active pharmaceutical ingredient to an Italian toll manufacturer, who then produced the drug in powder form. This powder was sent to another tolling company in France to be further processed and pressed into tablets. The tablets then went to a second French company to be put into blister packs. These packs were sent to the principal's central distribution warehouse for Latin America in Argentina, where the goods were put into secondary packaging that accommodated the various labeling requirements of the different regional markets. From there, they were distributed to customers all over Central and



South America. This arrangement resulted in the requirement for the principal company to be registered for VAT filings in no fewer than 12 countries because the goods involved in this supply chain remained in his ownership throughout. Additionally, this particular supply chain was structured in such a way that, in some countries, customs duty of up to 20% became due on imported products that would generally be free from such duties. One might think that the solution would be to restructure the supply chain, but the pharmaceutical sector is heavily burdened with government regulation concerning the manufacturing and handling of its products and so the options are, in reality, somewhat limited.

The main VAT question that arises from this is how does a company meet its compliance and filing obligations in 12 countries when it only has staff in one of those territories? This is among the first questions that any manager should be asking himself when considering moving to an international toll manufacturing arrangement. Failure to address these issues may lead the business into non-profitability and serious overseas VAT compliance problems.

GLOBAL CONTRACTS

Many multinationals are attracted to the idea that a single supplier can provide them with goods and services in numerous countries and then submit a single, central invoice for all those supplies. This sounds like a cost and time efficient move, but it is important that the parties to such an arrangement understand the complex VAT impacts of such a contract.

Example

A U.S. multinational contracted with an international advertising agency to originate and place its advertising materials in several countries, particularly in Europe and Asia. Up until this time, these activities had been carried out by the agency's local subsidiaries and they were billed to the multinational's local branches. The VAT charged on these supplies was recoverable by the multinational's branches. The new invoicing arrangement was that the agency's local subsidiaries would carry out work in each individual territory and then bill to their U.S. parent. The U.S. parent would then render a single invoice for all global services to its client. The problem that came to light was that, in many countries, the VAT regulations dictated that local VAT must be charged in respect of any services used and enjoyed within those countries, regardless of the possibility that the invoice might be sent to an overseas client. Therefore, several of the local advertising agencies charged this VAT to their parent, which then rolled these costs up into its global invoice and presented that to its client. As far as the client was concerned, they were not paying VAT on these supplies but the tax was, in fact, hidden within the gross invoice value. As this was invisible to them, the client was unaware that, in the course of the first two years of the global contract, more than \$2 million of VAT had been passed through to them by the advertising agency and none of that tax had been reclaimed, as it would have been under the old invoicing arrangements.

What this illustrates is that, where supply chains are amended, the corresponding VAT impacts must be carefully considered and discussed between the parties to ensure that new cost-efficiency measures do not simply turn into additional costs.

CENTRAL PROCUREMENT

Another popular restructuring strategy of recent times has been the introduction of central procurement companies that can leverage a group's buying power and so reduce costs. One of the main problems that has arisen in this type of structure, however, has been that the procurement



company may end up with numerous VAT registration and filing liabilities through its ownership of goods located in various countries.

Example

Take a very simple example as an illustration; imagine that a U.S. group has a subsidiary operation in Germany and that its key overseas suppliers are located in China and Germany. The group establishes a central procurement company in the U.S. that is responsible for buying all significant goods and services and then supplying those to the group members. When the procurement company purchases goods from China that are destined for the German subsidiary, it has to take title to those goods at some point during the physical movement of those goods. Does it take title in China? If so, it will need to register for Chinese VAT, as it will be the exporter of the goods. Does it take title in Germany? If so, it will be subject to the German VAT system because it will be both purchasing and selling the goods within Germany, that is to say that it will make local supplies there. For goods being sourced from the key German supplier and destined for the group's German subsidiary, the goods will never leave Germany whilst in the process of being bought and sold, so the procurement company would, again, be liable to account for VAT in Germany.

It can be seen from this very simple example that several VAT issues arise in respect of central procurement companies and it is likely that overseas VAT reporting would be required. When this simple model is multiplied up to reflect the reality of many multinationals that operate in dozens of countries, it takes little imagination to realize that a group's procurement company could very well trigger VAT registration and filing liabilities in all of those jurisdictions. Operationally, this additional administrative burden may be justifiable but the question remains of how will this tax be recorded, reported, managed and controlled from a central location?

SHARED SERVICE CENTERS

The last ten years has seen an explosion in the number of shared service centers established to centrally carry out a variety of functions that had previously been carried out in a decentralized manner by the group's operating companies. One such function is finance and accounting, including VAT compliance and filing responsibilities. Thus, a central location within an organization can find itself bearing the burden of filing VAT returns in multiple countries. Whilst this might make sense from a cost saving perspective, there are several VAT pitfalls that must be recognized and dealt with:

- Most countries require accounting records and tax filings be maintained in the local language. The same language issue arises over correspondence with local tax authorities;
- The service center should usually be expected to administer VAT audits in different jurisdictions but the movement of the accounting function to a central location often means that local expertise and experience is lost to the group;
- Some tax authorities are reluctant to have tax accounting be carried out outside their own territory. Additionally, virtually all countries will insist that VAT audits be conducted in the local country. The movement of the tax accounting function will create problems in these areas, to say nothing of the effects of losing the relationship between the taxpayer and tax authorities; and
- Who will sign the VAT return forms?

These issues point towards the need for country-specific VAT training, retention of key personnel who have deep local knowledge and the creation of formal procedures for multi-country VAT accounting and administration.



OUTSIDE INFLUENCES AND THE IMPACT ON VAT

It is not always an event from within a company that may be the root cause of a change in the business's international VAT footprint. In the last year alone, we have seen ten additional countries join the European Union; new rules have been introduced concerning VAT accounting for companies supplying

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services by electronic means (i.e. over the Internet); consultation documents are circulating considering wholesale changes to the VAT place of supply rules; and new regulations governing electronic invoicing have been issued. In the future we can expect to see yet more entrants to the E.U. and a range of further VAT simplification measures being proposed. From a single market perspective, a

key goal of the European Commission is to create an “origin system” for VAT, under which intra-E.U. supplies will be taxed in the country where the supplier is located (country of origin) rather than under the current rules, which identify the country of destination (i.e. where the customer is located) as the place of taxation. One of the greatest challenges facing U.S. multinationals is keeping abreast of all these changes which, when coupled with the innumerable rate and rule amendments occurring in individual jurisdictions, represent a steep hill to climb to achieve a solid level of assured compliance.

Is all this a matter for concern or should it be? At least for SEC registrants, the answer is, obviously, “Yes!” A heightened focus on cash flow analysis under Sarbanes-Oxley has brought transaction taxes to the forefront of the corporate consciousness. Each year, CEO's and CFO's are being required to certify to internal controls over tax positions and cash flows and their independent auditors are required to attest to the sufficiency of these controls and the accuracy of management's assessments. How can this be appropriately achieved in the absence of any central management understanding, participation and active control over 20-30% of overseas cash flows? At this point in time, most U.S. multinationals do not even measure their exposure to VAT on a global basis and they certainly do not understand how this tax impacts their businesses.

TAKING CONTROL OF YOUR VAT POSITION

There are really only three options available to U.S. multinationals when it comes to taking central control of their global VAT positions. They are:

1. Establish a network of people internally who have specific responsibility for VAT in their own countries. A U.S. coordinator could then gather necessary data from the network, including information concerning filings, regulatory and process changes, audits, compliance problems and VAT planning opportunities that could be leveraged cross-border. The coordinator could then keep the CFO and/or CEO apprised of the global VAT position. The upside of this approach is that it costs little in terms of cash, though it may be time consuming. The downsides are that a network of staff members and a coordinator need to be pulled from their normal jobs to participate and that few staff members of a multinational have any particular expertise in VAT, so the quality of the network's output may be questionable.
2. Outsource this task, either partly or completely, usually to an international accountancy or consultancy firm. This approach is likely to yield a higher quality of VAT information for the company and, as most consultants keep at least one eye on tax planning opportunities, this can also be an effective way of keeping abreast of such ideas across multiple territories. Further, by maintaining an on-going dialogue with the consultants and through training courses, it is possible to engineer a substantial knowledge transfer from the consultants to internal staff.



The flip side of this, of course, is the cost. In order to outsource this function completely may require significant budgets being put aside, though it would be more cost-effective to create a hybrid position involving partial outsourcing and devoting some resources internally to the effort.

3. U.S. multinationals using ERP systems also have the option to automate the global VAT accounting function. VAT automation is still in its infancy, but it is essentially no more than an international extension of U.S. Sales Tax automation, which has been available for years. VAT automation works in much the same way as its Sales Tax counterpart, being based on a bolt-on software package containing the VAT rates and rules for many countries. When the user inputs data to the Accounts Receivable or Accounts Payable system, the automation software examines that information in order to determine in which jurisdiction the supply should be taxed and also the rate of tax applicable to the transaction. Additionally, ever-evolving reporting functionality provides VAT data reports that assist the user in completing VAT return forms. In brief, the benefits of automation include:

- Regular software updates keep user systems current with rate and rule changes in foreign markets and the place of supply logic that is essential to identifying the jurisdiction in which tax must be accounted, all without any research effort on the part of the user;
- The automation software is able to make the taxability decision far more reliably and consistently than a data input clerk or the native functionality of an ERP system could achieve;
- It is a cost-effective solution for managing global VAT performance and a reliable data source on which to base global VAT strategies; and
- Central management has a good level of visibility into the company's global VAT position, providing assurance that Sarbanes-Oxley obligations can be met with far greater confidence.

CONCLUSION

Even before the advent of the Sarbanes-Oxley Act of 2002, U.S. corporations should have been actively measuring and managing their international VAT positions. After all, if 20-30% of the business's total overseas cash flow is represented by VAT, it would seem to make perfect business sense for central management to be on top of the situation. However, as VAT is rarely identified as a separate item in U.S. accounting systems, it assumed an almost invisible status and slipped under the radar for a long time. Now that the requirements of Sarbanes-Oxley have become more familiar to U.S. companies, the knowledge gap that exists in respect of VAT should be a matter of considerable concern to businesses.

Whether U.S. corporations seek internal, external, or automated solutions to this problem, the first step in seeking VAT compliance must be to understand how VAT finds its way into and out of their businesses and then to measure the global impact of this tax. I am confident that, once the impact is understood and measured, VAT will assume a far higher priority in the minds of both central management and the external auditors of U.S. multinational companies.



About Chris Walsh

Chris Walsh is the VAT Practice Leader for Vertex with 20 years of indirect tax experience. Prior to Vertex, he held tax management positions at PricewaterhouseCoopers, Rothmans International, Foster's Brewing Group Europe, Scottish & Newcastle, Midland Bank Group, Clark Whitehill, and U.K. H.M. Customs & Excise. He has been active in value added and indirect taxes in more than 30 countries, including the U.K., Kenya, Ireland, and the United States.

At Vertex, Walsh serves as a VAT resource expert to both internal and external clients and has responsibility for managing the Vertex VAT product.

About Vertex Inc.

Vertex Inc. is the leading provider of tax technology solutions, serving more than 10,000 customers worldwide. Vertex solutions automate processes and enhance decision information across every major line of business tax including income, sales, consumer use, value added, communications, and payroll. To serve its customers, Vertex works in partnership with leading software and service providers, including SAP, Oracle, Microsoft, J.D. Edwards, IBM and PeopleSoft. Founded in 1978, Vertex is headquartered in Berwyn, PA and has offices in Atlanta, Chicago, Dallas, Sarasota and Washington, DC.

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