Finding a new balance
The rise of indirect tax

The role of indirect tax in mergers and acquisitions
Africa’s new potential, and shifting challenges
Building deeper ties with the rest of the business
The growing global momentum toward indirect tax

Dear Reader

Indirect taxes are booming. As governments around the world continue to struggle with the fall-out from the financial crisis, they are increasingly turning to increases in VAT, excises and other indirect taxes as the most straightforward ways of raising additional revenues. They are also using indirect taxes to influence behavior by taxing consumption of certain goods such as fuel, tobacco, snack food or alcohol.

This highly dynamic indirect tax environment poses many challenges for businesses, particularly those that operate across borders. Rates of VAT, excises and duties vary from country to country leading to errors easily arising on the classification of sales and purchases and uncertainty over how some transactions should be treated. Therefore companies must deal with the risk of non-compliance and ineffective processes by spending an increasing amount of time managing their indirect taxes and focusing on the changing regulatory trends to manage such complexities.

Supply chain complexity adds to the challenge. In many industries, companies have multiple tiers of suppliers producing components that will cross national borders many times before final assembly. They will often source manufacturing in low-cost jurisdictions, where tax regimes are often more complex and uncertain. This creates serious risks for corporates, which must ensure that they keep up with obligations, comply with rules for invoice formats and meet payments when they are due.

In the past, companies could afford to see indirect tax as an administrative issue. But the scale of the challenge has now become so great that many are rethinking this approach and ensuring that there is much closer co-ordination between the tax function and the business. But as well as managing the risks, companies should also consider the opportunities. By taking a proactive approach to managing indirect tax, and including it as a factor in their strategic planning, companies can gain an important advantage over their less agile competitors.

In this issue of T Magazine, we examine current trends in indirect tax and explore their impact on business. We look at the role of indirect taxes in addressing fiscal challenges, and examine how different countries are approaching key policy issues. But first and foremost, we look at the impact of these trends, as well as decisions which business leaders should take. We show how leading companies are managing their indirect tax burden, and look at the skills and capabilities that are required to manage the risks, and seize the opportunities from effective handling of indirect taxes.

We hope you find the publication valuable and stimulating.

Stephan Kuhn

Stephan Kuhn is Area Tax Leader for the Europe, Middle East, India and Africa (EMEIA) region at Ernst & Young.
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“The main challenge for governments right now is the question of how you address the fiscal consolidation needs of government with a tax system that is good for growth.”

Pascal Saint-Amans, Director of the OECD’s Centre for Tax Policy and Administration (see page 16).
Global tax news
A roundup of recent developments from major governments and tax administrations

1. Angola  
   April 2012  
   New tax incentives will support Angolan oil companies whose capital is entirely held by Angolan individuals. Those with a production sharing agreement with the national concessionaire, Sonangol, will see their oil income tax rate reduced from 50% to 35%, the standard corporate income tax rate. Those in joint venture operations will have their rate cut from 67.75% to 35%. All Angolan oil companies will also enjoy exemptions from payment of signing bonuses, certain financing obligations and the required contributions to social programs.

2. Greece  
   April 2012  
   A new national personal income tax system has been proposed including five tax brackets: 0%, 10%, 20%, 30% and 40%. This will abolish the rates of 18% and 25%, which favored mainly low- and average-income taxpayers. All tax exemptions will be abolished under the new system, as will many deductions, such as those for life insurance, social security contributions and medical expenses.

3. United Kingdom  
   March 2012  
   The 2012–13 budget cut the corporation tax rate from 26% to 24%, falling to 22% in 2014. The publication of the Finance Bill took forward the new CFC rules and the introduction of a Patent Box regime. For individuals, the top rate of tax has been cut to 45%, from a prior maximum rate of 50%. At the same time, the personal allowance will be increased to £9,205. The Government is considering measures to cap access to tax reliefs for individuals, with consultations to follow.

4. Australia  
   April 2012  
   The Minerals Resource Rent Tax (MRRT) became law and is effective from 1 July 2012. Company tax rates will be reduced to 29% in 2012–13, from 30%. It is current government policy that the rate for other companies will also change from 2013–14. A number of other tax law changes for small businesses were also enacted. These include an increase of the asset write-off threshold from AU$1,000 to AU$6,500, a simplification of tax depreciation pooling arrangements and the introduction of an accelerated depreciation for motor vehicles.

   The superannuation guarantee (a mandatory payment to employees’ private pensions) will also be gradually increased to 12% by 2019.

5. India  
   March 2012  
   The Finance Bill, introduced in the Parliament as part of the budget proposals, contains far-reaching tax proposals for amending the Indian tax laws. Its key proposals include taxation of offshore asset sale transactions, retrospective amendments to the definition of royalty, amendments to transfer pricing agreement and introduction of General Anti-Avoidance Rule (GAAR). On 7 May, the Finance Minister proposed to defer the implementation of GAAR by a year.
Tax reform in the spotlight

Countries around the world are striving to reduce tax complexity and increase revenues. The sweeping approach to this is to broaden the VAT base and move to a single rate. A less dramatic alternative is about simply tidying up, or as the UK’s recent budget described it, “address borderline anomalies.” But these can be controversial. Removing zero and reduced rates for certain goods and services (like pasties, for example) is the removal of a measure that is typically set up to protect low-income groups. But there is now a growing consensus that better ways exist to help low-income populations. An increase in VAT revenue, for example, could be used to increase support payments. Countries like New Zealand also show that broad-based, single-rate VAT systems generate more revenue with less administration. As such, many countries are now looking for routes to improve the complexity of their VAT systems. The European Commission has recommended since late 2010 that EU Member States move to a broad-based VAT system, ideally with a single rate. The question that remains is how likely such reforms are, not least amidst the wider challenges being faced within the Eurozone today.

Value added tax (VAT)

<table>
<thead>
<tr>
<th>Country</th>
<th>Standard rate in 2010</th>
<th>Standard rate in 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>25%</td>
<td>27%</td>
</tr>
<tr>
<td>Sweden</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>17.5%</td>
<td>20%</td>
</tr>
<tr>
<td>Germany</td>
<td>19%</td>
<td>19%</td>
</tr>
<tr>
<td>Russia</td>
<td>18%</td>
<td>18%</td>
</tr>
<tr>
<td>South Africa</td>
<td>14%</td>
<td>14%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>7.6%</td>
<td>8%</td>
</tr>
<tr>
<td>Singapore (GST)</td>
<td>7%</td>
<td>7%</td>
</tr>
<tr>
<td>Japan (consumption tax)</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Source: Ernst & Young

Rising average of VAT rates across the EU-27

After the crisis direct tax revenue across the EU-27 continues to fall while indirect tax revenue moves upwards

The age of VAT

1950

The first country to introduce a VAT system.

1954

1967

Brazil and Denmark introduce VAT systems, soon to be followed by Germany, Sweden and the Netherlands. By 1969, eight countries have a VAT.

1970

The UK introduces a VAT, as do Austria and Italy. By 1979, 27 countries will have a VAT system.

1973

1986

New Zealand introduces a goods and services tax, with a broad base and a low single rate.

1989

Japan introduces a VAT system, bringing the total number of countries to 53.

1991

South Africa and Canada introduce VAT, followed during the 1990s by Poland and Switzerland, among others.
“It’s an extraordinarily complex situation when you are having to check with the Meteorological Office on whether or not to add VAT on pasties.”

UK Labour MP John Mann commenting on new VAT rules introduced with the UK Budget during a government Select Committee hearing.

1,700
The number of submissions received by the European Commission from businesses, academics, citizens, tax authorities and professional services providers in response to its Green Paper on VAT reform.

2001
Worldwide, 129 countries now have a VAT system.

2006
A European Council Directive requires Member States to have a minimum VAT standard rate of 15% and one or two reduced rates not to be below 5%.

2009
VAT receipts represented on average 7.4% of the GDP of a EU Member State in 2009, an increase of almost 10% from 1995.

2010
The European Commission releases a Green Paper recommending “a broad-based VAT system, ideally with a single rate.”

2011
Hungary announces that the standard rate of VAT will rise to 27% in 2012, the highest in the EU.

2012
Some form of VAT/GST now applies in 156 countries worldwide, accounting for an average of one-fifth of total tax revenue.

2000

156
VAT systems including goods and services taxes (GST) now exist in 156 countries around the world, with seven more considering implementation by 2013, according to the World Trade Organization.

New Zealand
With a broad base, a low single standard rate and few exceptions or exemptions New Zealand scores the highest on the OECD “VAT revenue ratio.” This measures the gap between the theoretical revenue that would arise from a single rate with full compliance and full tax collection, and the actual revenue collected.

China
On 26 October 2011, the Chinese Premier Wen Jiabao announced that from 1 January 2012, Shanghai would start the VAT pilot arrangements to trial the convergence of VAT and Business Tax (BT) progressively. The current VAT and BT regimes have caused cascading effects and improvements have to be made in order to support the development of modern services. VAT accounts for approximately one-third of the Chinese government’s tax revenue.

Six global indirect tax trends
According to the recent Ernst & Young’s Indirect Tax in 2012 report, six common global trends for indirect taxes can be identified that are likely to be significant in 2012 and beyond:

1. Increasing VAT/GST rates
2. Broadening of the VAT/GST tax base
3. Refinement of consumption tax systems
4. Increased focus by tax administrations on compliance and tax avoidance, using advanced technology
5. A continuing rise in excise duties
6. Decreasing customs duties from increasing free trade

20%
The United States could add an estimated US$1t tax revenue if they adopted a European-style VAT system with a standard rate of 20%. The US budget deficit in 2012 is US$1,327t.

2010
VAT receipts represented on average 7.4% of the GDP of a EU Member State in 2009, an increase of almost 10% from 1995.

2011
Hungary announces that the standard rate of VAT will rise to 27% in 2012, the highest in the EU.

2012
Some form of VAT/GST now applies in 156 countries worldwide, accounting for an average of one-fifth of total tax revenue.
Managing the dynamic landscape of indirect tax

Indirect taxes have risen to become the biggest type of tax that businesses deal with today, especially those operating globally. Although often a hidden burden, the impact on the bottom line is very real.

**Summary**
The deepening and widening of indirect tax regimes has become a widespread tax policy trend around the world. This in turn is leading to a rise in complexity for the tax functions of companies, with new risks to consider.

By Gerri Chanel

Though taxes are described in many ways, "extraordinary" is not usually one of them. But the story of indirect taxes is truly an extraordinary one. Consider the value added tax (VAT): Never before in tax history, as far as historians know, has a completely new type of tax arisen and then spread around the world to become a prime source of global tax revenue in little more than 50 years.

Indirect tax amounts are huge; they now make up about 75% of all taxes remitted by businesses globally, by far the largest type of tax under management by businesses. And the numbers are likely to go even higher: Both the OECD (see “Striking the right balance” on page 16) and the majority of policymakers polled by Ernst & Young in 2011 expect governments to generate even more revenue from indirect taxes in the future.

VAT, or goods and services tax (GST) in some countries, is being introduced in new jurisdictions virtually every year, while at the same time there is a constant rise in rates worldwide. Excise tax rates are also on the rise, along with new excise taxes on items such as energy, carbon and even snack food. This new landscape is creating multiple layers of complexity for multinationals, who must simultaneously deal with the many indirect tax implications of increased global commerce, deeper scrutiny by tax authorities, and the internal challenges of obtaining visibility over indirect taxes.

From newcomer to star player

Globally, indirect taxes include a wide range of taxes imposed on consumption rather than profits or income; thus the term "indirect." Some apply to a broad range of transactions, such as VAT/GST and sales and business taxes; other indirect taxes are assessed on specific transactions, such as excise taxes and customs duties.

Excise taxes are as old as the pyramids: The first tax on alcoholic beverages was imposed 3,000 years ago when the Egyptian pharaohs levied a tax on beer. On the other hand, even the idea of a VAT is not documented prior to the 1920s and the first national VAT, enacted by France in 1954, was a limited one. Yet VAT is now the most widespread general consumption tax in the world, implemented by over 150 countries, including all 34 OECD member countries bar one (the United States). Only five countries have ever repealed a VAT, and all but one (Belize) later reintroduced it.

This overwhelming enthusiasm led one IMF author to consider VAT as the tax world’s Mata Hari, the famous exotic dancer and courtesan of early last century, noting that “many are
Robert Langham

During the last 10 years, he has headed Philip Morris International's indirect tax group, providing guidance on compliance and strategic tax issues regarding VAT, excise tax and customs duties to its management and affiliates around the world.
tempted, many succumb, some tremble on the brink, while others leave only to return, eventually the attraction appears irresistible.”

What is it about VAT and other indirect taxes that makes them so appealing to governments? “Revenue authorities like them,” says Dr Philip Robinson, Ernst & Young’s Global Director of Indirect Tax, “because they are a more secure source of revenue. One reason is that consumption tends to be more stable than profits, even in a weak economy, so revenue streams from consumption taxes are not as volatile as those of income taxes.”

Another reason is that VAT, given its cascading nature from original inputs to final product or service, is better able to plug collection gaps than a retail sales tax, as every business in the supply chain has a strong, simple incentive to collect output tax on its sales: If it does not, it cannot recover the input taxes it has paid. Another advantage of indirect taxes, at least from a government perspective, notes Gijsbert Bulk, EMEIA Indirect Tax Leader for Ernst & Young, is that rates are generally easier to increase than for direct taxes. For example, in most jurisdictions, the VAT is already included in the sales price shown to the final consumer, making incremental rate increases far less visible to the consumer and thus also less likely to affect consumption. Generally there is no difference in the tax outcome for foreign or domestic entities; an import is taxed in a similar way to a domestic sale, reducing the incentive for companies to seek ‘low-tax’ jurisdictions. Economists also favor broad-based consumption taxes. For example, they are considered more neutral compared to other taxes in terms of affecting spending habits, investment decisions and the natural allocation of resources.

There’s a downside, however: Consumption taxes tend to have a greater impact on lower-income individuals, who spend a bigger share of their income. “In principle,” says Robinson, “if every type of consumption was taxed, the tax would in a sense be regressive. But in most systems, basic goods and services are either exempt or subject to reduced rates to help reduce the impact.” Because these reductions apply to everyone and also make tax systems more complex, economists tend to favor other means of offsetting regressivity, such as tax credits, direct payments and various forms of social support for affected households. But as indirect taxes have boomed, so too has their impact on businesses. “However,
that impact is often underestimated since most companies look at indirect taxes simply as flow-through taxes,” says Robert Langham, Director of Indirect Taxation at Philip Morris International, a global tobacco company.

With VAT, a company typically pays input tax on purchases, then simply subtracts it from the output taxes it collects from customers before remitting the difference to the tax authorities. “In reality, though, there is a huge administrative burden, much more so than for corporate income tax. Also, because these taxes don’t show up in that bottom line tax number, they’re generally hidden from the business – if the input tax is not recovered, then it effectively becomes part of cost of goods sold or the cost of doing business,” says Langham.

Robinson says that “even if the company miscalculates a fraction of their VAT/GST on the sales volume, the amount can be huge.”

Part of the complexity arises simply from the fact that there are very few, if any, jurisdictions with a single tax base or a single rate. Errors can arise on the classification of both sales and purchases, especially for activities that are subject to different rules in different countries. Input VAT/GST may not be recoverable due to payments that are not supported by correct documentation, or incurred in foreign jurisdictions that make recovery difficult. Alternatively, there may simply be genuine uncertainty about the correct VAT treatment of a transaction - and even if VAT is due.

**Rising complexity**

“The management of indirect taxes has changed fundamentally in recent years,” says Tamara Berger, Global Head of Indirect Taxes and Tax Technology at Agilent Technologies, a manufacturer of measurement tools. “There are increased numbers of jurisdictions, and many are imposing changes in their transaction taxes. Just keeping up with all these changes has been a challenge in itself. Other challenges arise as supply chains become more complicated, as companies ship from anywhere to everywhere.”

New types of services and the internet are also complicating factors, particularly in countries within the EU, where VAT frameworks were developed many years ago, says Claudio Fischer, of Ernst & Young’s EMEIA Tax Policy Development team. The issue is that online transactions, among others, were not contemplated in the original legislation.

Fischer points out that there are also challenges in meeting the disparate rules among jurisdictions for invoice formats. “For any given country, there can be up to 15 or 20 items that must be mentioned on an invoice in order to be allowed a particular tax treatment.”

Even apparently simple tasks can be complicated. Chris Needham, Global VAT/GST Director at GE, the global conglomerate, points out that “it’s very hard to know what’s going on in some countries quite simply because they don’t have information on their websites, or the website is in a local language. In some countries, it’s impossible to obtain rulings and in other countries, it’s even difficult to obtain the VAT forms.” (Read the full interview with GE’s Chris Needham on page 24.)

“All these tasks become even more challenging in emerging markets, whether in Asia or Latin America or elsewhere,” Robinson says. “In such markets, companies often have less familiarity or expertise with the local consumption taxes - and some of the indirect tax regimes, such as Brazil’s, are extremely complicated.”

**The many faces of indirect tax**

**Excise duties on the rise**

__ When broad-based VAT systems were implemented in many countries in the 1970s and 1980s, many product-related taxes were eliminated. These taxes are now making a comeback – and the rates are going up – in areas where governments see them as a tool for influencing consumer behavior. For example, there have been constant increases in excise duties on alcoholic beverages, mineral oils and tobacco products.

A number of other new taxes are being introduced as well. One category aims to improve eating habits. France recently enacted a new soda tax, while Hungary has introduced a tax on goods with high fat, sugar and salt content, including soft drinks. Denmark and several other European countries already have taxes on these types of food items.

Another new high-profile excise tax category is environmental or “green” taxes aimed at reducing pollution and climate change. Langham says that “over the last three or four years, there has been an exponential rise in the number of countries implementing taxes on things like carbon emissions, packaging, and other types of waste.”

**69%**

In Ernst & Young’s 2011–2012 Tax Risk Survey, 69% of tax policy-makers surveyed expect to generate more revenue from indirect taxes in the future.
Indirect tax management at Philip Morris International

As Director of Indirect Taxation for Philip Morris International (PMI), the global tobacco firm, Robert Langham is responsible for all aspects of the company’s indirect tax management. Here, he speaks to T Magazine about how the company’s approach to indirect taxes has changed in recent years and how the company manages its indirect tax risk profile.

**T Magazine: In what ways has PMI’s approach to indirect taxes changed in recent years?**

**Robert Langham:** It comes down to two things. First, a desire to manage indirect taxes more effectively. Second, we’ve gone through a lot of business process change and centralization that has required us to take a look at how we’re managing a lot of these taxes, as we move back-office finance functions to shared service centers. This basically requires you to reassess how those transactional taxes are being administered.

**What are some of the things you’ve done to manage indirect taxes more effectively?**

We’ve placed all of our taxes within a strong tax risk management and control framework so that we have good risk assessment processes, decision-making and escalation processes and internal control review mechanisms to see how things are working. And we have been able to improve processes over time. We have implemented a lot of enterprise resource planning (ERP) tools and non-system tools as well, such as a global database that provides guidelines on best indirect tax practices, benchmarking against other companies and so on.

PMI deals with a wide range of indirect taxes. How does this fact impact management of the tax function?

VAT, which most people think of as “the” indirect tax, is sort of in the middle of the field for us in terms of its size. Administratively, it’s definitely one of the most burdensome taxes, but obviously, dealing in excisable goods, there’s an administrative burden for the excise and other consumption taxes as well. We look at them somewhat together, since excise is nothing but a glorified VAT on a particular good. One challenge is that the bases, trigger points and reporting requirements for each of these different taxes can be quite different. One of the most difficult aspects is trying to manage the business processes so that you pick up all these tax trigger points and bases and can reconcile them.

**At PMI, how does the indirect tax function interact with the rest of the business?**

We’re quite lucky here; we have one tax department that covers all taxes. And we’re extremely lucky in that the business unit affiliates look to us for guidance when they’re entering new lines of businesses or launching new kinds of products or setting up businesses. They’re quite responsive to our input. Part of that is probably because of the high profile that compliance takes at our company. But we’ve also done a lot of stakeholder outreach over the years, to try and make sure that we build and maintain those links. Also, as new business lines and new operations get developed, we actively go out and try and make sure that they know who we are and what we’re doing and how it might impact them, or how what they’re doing might impact PMI’s overall tax risk profile.
familiar with local compliance requirements. And the service center must deal with countless transactions that originate in multiple countries and languages and fall under the auspices of a variety of cultures and authorities.

“Whatever a company’s reporting framework,” says Robinson, “companies not only need to make sure they get the rules and filings right in every jurisdiction, but also that they implement those rules correctly into their process and systems.”

Another hidden risk in indirect tax management is its impact on cash flows. These may be affected by a specific item, such as when a company incurs VAT/GST in foreign jurisdictions that is not refunded quickly. But even within a single country, the overall working capital cost of VAT/GST cannot be underestimated, especially where a business has a high ratio of outstanding sales, or a low ratio of outstanding purchases, or both of these. In short, the greater the amount of indirect tax “throughput” flowing through the system, the greater the demand placed on the company’s working capital.

**Rates go higher, tax bases get wider**

In recent years, the global financial crisis has accelerated a worldwide trend toward higher indirect tax rates. This is propelled in part by the ongoing struggle of many countries to balance budgets, but also the desire to fund social initiatives and tax reform in other areas.

This trend has been particularly strong in Europe. The VAT rate across the members of the EU hovered for many years around 19.5%, then started to increase after 2008. The average EU VAT rate has now passed 21%, and this trend looks set to continue in 2012, with Italy, Ireland, Cyprus and Hungary already having announced rate increases. Hungary’s new standard rate of 27% has broken the “magic barrier” for the top EU rate, which for a long time was believed to be 25%. Reduced rates are also going up in a number of countries, both within the European Union and globally.

Furthermore, the range of goods and services subject to indirect tax is also being extended. For example, Finland now taxes subscriptions to newspapers and periodicals, which were previously exempt, while Belgium has removed the previous exemption for services of notaries and bailiffs. Elsewhere, various new or increased excise duties are also being applied.

**Systems poised for change**

Many countries are in the process of refining and/or expanding their indirect tax systems, some in fundamental ways, says Robinson. These range from India’s proposed introduction of a new nationwide GST to a VAT pilot program in Shanghai. In the EU, where VAT has existed for many years (and is mandatory for EU membership), reform is also on the horizon, although there is much uncertainty about the likelihood of major change, given other economic distractions. Nevertheless, the European Commission is currently drafting new VAT legislation, due to be published in 2012, with the intention of simplifying the system and cutting down on fraud.

And some specific areas of progress can be found: Several countries have recently modified their rules to take modern technologies into account, for example. Iceland and Luxembourg have aligned the VAT treatment of electronic and print media to reduce the distortions caused when, for example, a printed newspaper is taxed at a reduced rate but buying the same newspaper online is taxed at the standard rate.

Given the increasing scope of indirect taxes, tax administrations around the world are putting a greater focus on indirect tax compliance. “We’re seeing a much more aggressive approach from tax authorities,” says Berger. “This has been changed quite fundamentally in the last five years. They very much want everything to be 100% correct or otherwise they will assess VAT liabilities or deny an input VAT refund; for them this is low-hanging fruit.”

Tax authorities are also intensifying their audit activities, often using new, more precisely-tailored methods - many of them technology-based – to detect tax abuse and avoidance. Many countries have also broadened the scope of indirect tax penalties and are imposing higher penalties.

One bright spot in the indirect tax picture is the overall pattern of decline in customs duties as countries conclude a growing network of free and preferential trade agreements, plus programs granting duty-free treatment to many products from developing countries. Langham notes that, as a result of these agreements, the effective import duty burden is starting to become relatively low. “There is a lot of administration that goes around ensuring that customs duties are negligible,” he says.

**Dealing with reality**

Governments around the world are increasingly looking to indirect taxes to balance budgets, fund tax reforms in other areas, promote and regulate trade, and support green policies and other social initiatives. This movement is being supported by the World Bank, the OECD and the International Monetary Fund (IMF), all of which favor indirect taxes, rather than direct taxes on income.

The landscape for indirect tax has clearly shifted and that shift appears to be a long-term one. In response, tax and financial executives will need to increase visibility over how the company’s indirect taxes are managed, as several articles in this edition of T Magazine detail. These taxes may be “hidden” but their impact on the bottom line is quite real.
Prices at the pump

Fuel tax policies vary widely around the world. Just within OECD countries, the tax component of the petrol price ranges from around 13% in the United States and Mexico to just under 60% in the UK, Norway and Greece. This makes tax the primary reason for the variation in fuel prices globally, well ahead of other costs, such as refining and distribution. Regionally, Western European countries have the highest rates of fuel tax worldwide, with an average of 55% of the pump price paid in tax.

Norway
Price: US$2.56/l
Tax rate: 59%

The Netherlands
Price: US$2.34/l
Tax rate: 55.7%

Germany
Price: US$2.22/l
Tax rate: 57.5%

Japan
Price: US$1.91/l
Tax rate: 42.3%

Petrol consumption in 2012 of the world total
0.3% 
0.8% 
3.3% 
6.5%

CO₂ emissions from oil combustion in 2012 of the world total
0.2% 
0.6% 
3.3% 
4.9%

Motor vehicles per 1,000 people

Sources: Australian Government, Department of Resources, Energy and Tourism; Economist Intelligence Unit; International Energy Agency / Graphic: Käthi Dübi
Global oil demand growth

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<tr>
<th>Year</th>
<th>mb/d</th>
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<tr>
<td>2010</td>
<td>88.32</td>
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<tr>
<td>2011</td>
<td>89.08</td>
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<tr>
<td>2012</td>
<td>89.90</td>
<td>0.9%</td>
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</table>

Sources: International Energy Agency 2012

Poland
Price: US$1.75/l
Tax rate: 51.1%

Australia
Price: US$1.51/l
Tax rate: 35.7%

Canada
Price: US$1.29/l
Tax rate: 30.6%

USA
Price: US$0.99/l
Tax rate: 13.2%

Mexico
Price: US$0.73/l
Tax rate: 13.8%

Saudi Arabia
Price: US$0.13/l
Tax rate: 0%

Sources: International Energy Agency 2012
The OECD’s Pascal Saint-Amans and Piet Battiau talk to T Magazine about the trend toward indirect taxes globally and the implications this holds for business. *Interview by James Watson*

**Striking the right balance**

Pascal Saint-Amans

Director of the OECD’s Centre for Tax Policy and Administration. Saint-Amans took charge of the centre in February, following the retirement of Dr. Jeffrey Owens. He previously led the OECD’s Global Forum Division, which worked on the transparency and information exchange.
Piet Battiau
Head of the OECD’s Consumption Taxes Unit.
Battiau leads a growing focus on consumption taxes, especially in the development of international VAT and GST guidelines. The Unit also considers the economic impact of taxes and related best practices.
T Magazine: Pascal, since taking over the leadership of the OECD’s work on tax policy and administration in February, what are the main tax issues you’re focusing on?

Pascal Saint-Amans: I have three priorities for my job, which I think relate to the most important issues on the international tax agenda. My first priority, in line with our work on setting standards, guidelines and principles for the international tax community, is to engage with non-OECD countries to ensure a global approach to international tax issues. One example is in indirect tax, where one of my goals is to put in place a global form of VAT.

The second priority relates to direct taxation. The most challenging issue we’re facing right now is transfer pricing. We need to explore how we can provide the international tax community with rules that are acceptable by government and implementable by business. These rules must ensure government revenue, but also the elimination of double taxation for business. So we’re working on how to address this issue through international tax instruments, such as OECD standards, rather than by unilateral defensive measures or other more aggressive approaches.

The third priority is tax policy. In the current economic environment, governments need money, but also new economic approaches that promote growth. There are many dimensions to this. Such policies need to reconcile a focus on growth with the reduction of inequalities, for example. VAT is included in this work, because it’s a key tax for growth, so we’re working on developing guidelines for international taxation. But beyond that, we also need to explore further the economic merits of VAT, including when is it appropriate, what is the best framework for business, and so on. We have 153 countries using VAT, but they currently have no forum to talk about the issues they face in dealing with related issues. I would like to see the OECD offering that kind of forum.

Tax is clearly in the spotlight for many administrations, especially within Europe. What balance do you think governments need to take between higher tax rates and tougher enforcement versus creating an environment for business to operate and grow within?

Pascal Saint-Amans: The straight answer, based on the usual tax prejudices, is that you need to have a broad base first. Second, you need to have low rates. Third, you need to avoid exemptions or any kind of loopholes. When you have such a system in place, then compliance is easier to ensure. That said, based on our work around taxes that are pro-growth, we think that the move toward indirect tax is probably better for growth than direct taxes. And, of course, VAT is a pretty good candidate there.

In terms of compliance, we’re doing work to improve this, which extends to indirect taxes. But, basically, what we advocate is an approach that would guarantee the revenue collection for the government and neutrality for the agent, while promoting guidelines internationally to avoid double taxation.

Many multinational businesses are battling to gain certainty on country-specific indirect tax rules amid a great deal of market uncertainty. What advice do you offer corporate tax directors trying to grapple with this?

Piet Battiau: One of the key objectives of our work on the development of VAT/GST Guidelines is to significantly reduce uncertainty related to the application of VAT in an international context. We have done a lot of work to understand the differences in approaches adopted by countries that operate VAT, such as how they treat international services. We’re now working toward a convergence in approach between those countries. The issue is not so much about the basic principles of VAT, but about the number of approaches used in practice and varying definitions on taxation issues. So, it is about implementing tax principles in practice.

In terms of advice to tax directors, we’d recommend they ensure that indirect tax risks have been properly identified and managed and that they keep track of what the OECD is doing in addressing the risks that result from current uncertainties in the international VAT area. We also encourage them to support us in finalizing that work by giving their input on the particular issues that they face, on the solutions that we propose and any issues that may still need to be addressed. Many businesses are already actively involved in our work, which is extremely valuable for both tax administrations and businesses.

Pascal Saint-Amans: The risks relating to indirect tax have been growing. When you talk to tax directors, specific issues around VAT often crop up as one of their key concerns. The tax director of a large US corporate told me that one of the major issues he faces is double taxation in the area of VAT, as one example. Another example is from the tax director of a multinational company who says the firm’s...
indirect tax risk was far bigger than its direct tax risk.

To what degree does the OECD see any prospect for better harmonization of indirect taxes across regions, including across the EU? Pascal Saint-Amans: Harmonization on indirect taxes within the EU is quite well advanced, but is also a bit blocked right now in terms of further progress. This is a difficult agenda to progress, given the need for agreement across 27 countries. So there is still work to be done and we very much support the EU’s ambitious review of the European VAT framework that was launched with the publication of its Green Paper on the future of VAT in 2010.

I do not see similarly advanced harmonization processes in other parts of the world. What I can see is that there is a trend toward indirect taxes, such as VAT, in a large number of countries, driven by the need to collect revenue. Can we see regional groups with harmonized VAT? No, not yet, even though the six Gulf Cooperation Council countries in the Middle East may be moving in that direction, as are the 15 African countries that form the South African Development Community (SADC) Free Trade Area. What we need to focus on at this stage is establishing guidelines that will reduce and, if possible, eliminate the risk of double taxation. Beyond that, we need to fix the deficiencies in some tax regimes through the sharing of best practices, which is where we can make progress.

Piet, is there much consensus globally around how a VAT system should run?
Piet Battiau: The question of harmonization in terms of VAT or indirect taxes is quite different than with direct taxes. Broadly speaking, there is international consensus on how a VAT system should be designed and operated. For example, there is broad agreement on the principle that VAT should be neutral for business and that it should be a tax on household consumption, levied at each stage of production. In an international context, taxation of cross-border transactions in the country of destination, where the consumption takes place, is the generally accepted standard.

But the question, in practice, is how to implement many of these features so that they interact consistently in an international context. As long as a government operates its VAT system within its national boundaries, this is not a huge issue, but there are some differences in the way in which these general principles are applied in an international context. For instance, how do you define destination? One country would define it as where consumption actually takes place. Another would define it as the country where the consumer is established. We need to achieve some consistency in how we apply these broadly accepted principles in practice, in order to avoid or minimize the risk of double taxation or double non-taxation. Of course, when we look at best practices, some of these are easier to implement than others and that’s basically what we’re working on.

The OECD highlighted the growing importance of VAT in a recent report. What do you see as the main VAT-related trends in the international environment? Piet Battiau: The first key trend is the continuous spread of VAT, which is now operated in twice as many countries as in 1992, combined with its continuously increasing importance as a major source of revenue for governments. A considerable number of OECD countries have increased standard rates over recent years, or have announced to do so, to address fiscal consolidation pressures. This has resulted in an unprecedented increase of the unweighted average VAT rate within the OECD, from 17.7% in 2009 to 18.7% at the beginning of 2012, whereas this average had remained stable during the 15 years before that. VAT now accounts on average for one-fifth of total tax revenues in the OECD and worldwide. It has become the third largest source of revenue for OECD countries as a whole, behind personal income taxes and social security contributions.

A second trend is the renewed interest in more fundamental reform of VAT systems, to improve their efficiency and revenue raising capacity. We mentioned the review of the EU VAT system before. Also Brazil, China and India, for example, are seeking to reform their VAT regimes to remove the cascading effect of taxes on top of taxes, and provide more uniform taxation of goods and services.

What do you see as the key areas that countries should be doing better at in terms of tax policy and ensuring tax compliance? Pascal Saint-Amans: I would say the main challenge for governments right now is the question of how you address the fiscal consolidation needs of government with a tax system that is good for growth. This is a very difficult challenge, because if you need money immediately, the best leverage is to raise the VAT rate. That’s the easiest solution.

But then I would add another layer of complexity. Governments need a tax system that is good for growth, but which includes all the other aspects of a tax system, such as the reduction of inequalities or the employability of people. It’s not simply about growth versus all these other social aspects; they all need to be carefully balanced within this. So how do you combine all that?

This is what the OECD is trying to cope with in its new economic approach. I think it’s quite challenging and interesting and that’s where I think tax policy work can be of critical importance, which is why it is one of my priorities.
Indian Finance Minister Pranab Mukherjee announced the introduction of the country’s GST by August 2012 as part of his budget speech.
Improving India’s competitiveness

India is edging toward the introduction of a goods and services tax (GST), amidst much political debate. Dr Vijay Kelkar, the chief architect of the tax, makes the case for reform to T Magazine.
India is on the threshold of a fundamental reform of its indirect taxes. The changes will transform the economy by replacing a large number of levies with a comprehensive goods and services tax (GST) that will affect every business in India, domestic and foreign, small and large. The key question is how long it will take to implement. The reform will centralize tax administration, and many states are resisting the partial loss of fiscal autonomy.

The chief architect of GST, Dr Vijay Kelkar, says the proposed tax measure “is the next big thing in India’s reforms.” He says it will take “at least 12 to 24 months” to implement, despite already having experienced long delays. Even this may seem optimistic in view of the scale of the reform and the complexity of the politics. Yet, the arguments in favor of GST are strong and Indian companies generally support the changes.

As the name of the tax implies, all goods and services will be brought under it. Leaving aside a few items, such as alcohol and tobacco, which would attract a surcharge, all goods and services will be subject to just the GST, consisting of a state component (SGST) and a central component (CGST). GST will replace a number of central and state-level taxes, including the excise duty, service tax, VAT, central sales tax and luxury tax.

**Tough politics**

Indian policy-makers have been discussing the reform of indirect tax since the 1980s. Dr Kelkar, a former finance secretary to the Central Government and director at the International Monetary Fund, recommended an overhaul of indirect taxes in 2002, when he was advisor to the then Indian Finance Minister, Yashwant Sinha. But it wasn’t until the 2009 general election that the push to introduce a GST began in earnest, when both the ruling party and the main opposition parties included a GST in their election manifestos.

A few months later, the 13th Finance Commission entered the debate. This is a constitutional body appointed every five years, which aims to balance the financial relationship between the 28 states and the central government (the center). Chaired by Dr Kelkar, the Commission made detailed recommendations for a “grand bargain” between the center and the states that would enable GST to be implemented. This consisted of six elements that will be required to put into effect a “model” GST. These include the design of the tax, the method of implementation and the timeline.

The central government, formed by a coalition led by the Congress Party (whose election manifesto included a GST), wanted to introduce the tax by April 2012. But this required the agreement of the states and an amendment to the constitution to empower both the center and the states to levy the GST. The constitution currently says that states can tax goods, but only the center can tax services. The center can also impose excise duties on goods at the time they are manufactured - not at subsequent stages in the supply chain. This is an awkward tax regime: The center can tax goods only at the manufacturing stage and the states cannot tax services.

A GST would do away with this regime entirely, enabling the states and the center to tax both goods and services at each stage of the supply chain. But this does not mean that national and state governments would necessarily be in concordance. The states want to be able to decide which items to exclude from the GST and at what rate. But the Finance Commission opposed this, arguing for a flat GST rate of 5% for the center and 7% for the states, and allowing only a tiny number of exempted items.

Until now, no agreement has been found on the basic rate of GST and what goods and services should be exempt. But as the reforms have stalled, old-fashioned politics has intervened. Certain states, led by the opposition parties, are holding back their support to negotiate additional financial compensation from the center or other concessions. The national opposition Bharatiya Janata Party, which was originally in favor of the GST, is also not yet coming out firmly in favor of the tax. According to Kaushik Basu, the government’s Chief Economic Advisor, the opposition, having realized that the GST is a good reform, is now reluctant to let it happen under the current regime.

**The argument for GST**

Politics is delaying reforms, but the economic arguments in favor of a GST are powerful. First, it will broaden the tax base. By including almost all services, as well as almost all manufactured goods, the rate of tax can fall from the current combined excise and VAT level in the range of 22% to a GST of 12%, without lessening tax revenue. Some economists have argued that the revenue-neutral rate of GST would have to be a lot higher than 12%, but this doesn’t necessarily take into account the large expansion of the tax base.

Second, it will simplify tax collection, which at the moment is so complex that businesses are frequently unsure as to what taxes they should pay. For example, firms will no longer have to pay “additional customs duty,” “additional excise duty” and “special additional duty.” It would end the confusion over what constitutes manufacturing process, manufactured goods, and services. And it would do away with one of the worst aspects of the current regime: cascading taxes, caused by taxation of inputs and intermediate goods, as well as final consumer goods. Financial services firms, for example, pay VAT on the goods they buy, but they do not collect...
Fourth, it will allow more effective taxation of services, whose share in the consumer basket is increasing with growth in per capita income.

**Keeping an eye on growth**

Perhaps, most importantly, a GST would help create a single market in India. Right now, interstate shipments attract the Central Sales Tax (CST), which is enacted by the center, but collected by the states. When a supplier ships its products across state borders, the goods attract the VAT in the state where the goods are bought, and also the CST in the state from which the goods are supplied. As the goods manufactured and sold locally would attract the VAT only, the CST acts as an impediment to free movement of goods within the common market of India.

A single, nationwide GST would remove the tax disparities between states and, in theory, reduce the need for the border checkpoints that currently slow trade. These checkpoints are supposed to deter tax evasion, but may provide the opportunity for inspectors to charge additional unofficial taxes.

Taken together, the removal of these distortions is likely to stimulate the economy. The Finance Commission estimates that a fully implemented GST will enhance India’s gross domestic product by between 0.9% and 1.7%. That’s a sizeable boost, particularly at a time when growth rates have been falling. India’s GDP grew by only 6.1% in the fourth quarter of 2011, high relative to many other economies, but nearly two percentage points lower than in the previous years.

With so many arguments in its favor, it may seem surprising that a GST has not been implemented more quickly. But the main stumbling block is India’s constitutional framework for division of taxation powers. The states and the center have the difficult task of reconciling fiscal harmonization with fiscal autonomy. A decision on the grand bargain for a GST requires an agreement between the center and the states to amend the constitution. The center is keen to have these powers extended for only the fully harmonized GST that is uniform in all of the states. The states see this as a significant constraint on their fiscal autonomy.

One way out of the stalemate, says Poddar, could be to have a harmonized GST with the flexibility to allow individual states to opt out of the GST, should they so decide. Dr Kelkar is sympathetic to the states’ dilemma: “There is a genuine feeling among the states that they will lose autonomy. It takes time to persuade them and so we need to deal with them patiently.” He says that foreign multinational firms can play their part in persuading policy-makers of the merits of GST. “They should say how a GST has helped other countries,” he says, citing examples such as New Zealand, Australia, Japan and Singapore. India’s state governments, keen to attract foreign investment and support growth, are bound to listen. The question is when.

Dr Vijay Kelkar  
He is a renown economist and academic and the Chairman of India’s 13th Finance Commission. Dr Kelkar is one of the instrumental architects of the country’s impending introduction of a goods and services tax.

VAT on their fees, so they hide the cost of the VAT in the fees they charge. These are then passed on to the manufacturer that receives the service and is shifted forward by the manufacturer in the form of higher prices, and so on.

A GST is more transparent and is collected at each stage of the supply chain. It is therefore more difficult to evade. If shopkeepers, for example, do not report a sale, they could only avoid the additional tax payable on the value they add. The tax already paid by them to their suppliers (on their purchases) would then not be recoverable by them.

Third, a GST shifts the tax burden from investment, production and exports to domestic consumption. While there is not explicit tax on exports, taxes on investments and current business inputs, and other forms of cascading, do feed into the cost of exports. “The current regime can add 4%-5% to the cost of investment,” says Satya Poddar, a leader for Tax & Regulatory Services at Ernst & Young in India, “so GST is likely to have a substantial, positive effect on investment.”

Credit: Amit Dey
Chris Needham

In November 2011, the International Tax Review identified Needham as one of the “50 biggest influences in international tax.” He has spent the last 17 years developing GE’s 133-person strong Global VAT and GST team, which helps GE manage its approximately 5,000 legal entities around the world.
Chris Needham, GE’s Global VAT and GST Director, emphasizes the most important priority for any VAT team is to manage risks. He speaks about how to address new challenges which arise from worldwide indirect tax exposure.

Interview by Fergal Byrne

Rethinking GE’s approach toward indirect tax

T Magazine: How would you describe the landscape for indirect taxation in Europe today?
Chris Needham: With the economic downturn, governments are looking to protect whatever revenues they can. On the other hand, fraudsters are targeting the VAT system, as the current model in the European Union clearly lends itself to various types of fraud. Both governments and business are faced with the challenge of managing this risk. From the corporate standpoint, various forces are coming together to make it much more difficult for large, well-known businesses, those who want to comply, to actually comply. More often, we see EU Member States complaining about carousel fraud and increasingly holding business to account. But on the other hand, we also see blatantly abusive penalty regimes, which we believe are clearly in breach of the European principles of neutrality and proportionality. We often see tax authorities raising assessments where there’s no tax loss. So I think businesses are looking for some kind of equity.

Given all this, how do you approach risk management within GE?
The most important priority for any VAT team is to manage risk. To do that, you have to first measure risk. At GE, we measure what we call “VAT under management” for each of our 5,000 legal entities around the world. Historically, many have focused their risk analysis of a company’s net VAT exposure, which is the VAT it owes the government, less what it has paid on its own purchases. Instead, our focus is on VAT under management. We start with VAT on sales. We then add to the VAT on our purchases, and self-assessed VAT on things such as imported services. And more importantly, we add the value of the goods we export or we move within the European Union. In our view, that’s where the real risk is in Europe: intra-Community transactions. So we impute the VAT that we haven’t charged back and add that into the calculation as well. Once we have calculated VAT under management, we then need to identify the riskiest areas, to focus on where we are getting most of our assessments and face the biggest risks.

Summary
Dealing with indirect taxes is not just a finance consideration, but a direct risk issue. In response, GE has been evolving the skills, systems and organizational structures it uses to effectively manage such risks.
Given the deeper complexity in all this, what kind of skills are now important for dealing with indirect tax?
When we first started 17 years ago, there were no VAT people in GE. I was the first one, and now, 17 years later, we’ve got 133 employees. The skills that are needed have been changing over time and I have identified five different skill sets that are important today.

When we first started, we recruited the traditional Big Four technical experts who had probably come from the tax authority as a VAT inspector. You can achieve a certain amount - giving good advice, helping with acquisitions and disposals - with those kinds of skills. But increasingly, we also need to deal with VAT questions around compliance, reconciliations and documentation. And to do that, you need people who’ve got more accounting skills and are also informed and competent in VAT.

Then there is the technology side. We need technology-literate people to build our VAT portal to prepare the return, which is our third part of the skills puzzle. A more recent development is on the policy side, which is about interfacing with government administrations and doing the policy work. And, of course, there is also the corporate side, as the businesses themselves need to have their own VAT people. These are business VAT managers who’re looking at the enterprise resource planning (ERP) systems and the transactional side of things.

How easy is it to find the right talent?
It depends on the country. In countries such as the UK and the Netherlands and, to a certain extent, Ireland where the Big Four have always recognized VAT as a specialism in its own right, it’s not hard at all. However, in Germany and France, or across Latin America where you often have generalists, people who do corporate tax and VAT, it’s far more difficult as VAT hasn’t been seen to be a specialism in its own right. So if you want to recruit somebody there, they don’t always see it as a profession.

What role does technology play in helping to manage the indirect tax function?
I think technology is crucial in two respects for VAT. First, at the business level in terms of ERP systems and the accounting systems, this is vital. But technology is also at the corporate level.

Head offices see that many of their businesses operate across different accounting systems. As such, you’ve got to have some process or IT tool that can integrate information from all these different systems in a reliable way.

One of the key roles of the corporate VAT team should be providing information to the different businesses, with every business having the same access to information. About ten years ago, we started to develop a standard process for every country in the world, where you could prepare a VAT return online, review it online, deal with documents and reconciliations online, using a single portal for every return. And to do that, we had to build some sophisticated technology, because there was nothing available. We have built very sophisticated internal websites by country, by business type, by topic, where there’s a vast array of information that our businesses now have access to.

How do you get the balance right between a desire for centralization and also being locally responsive, in terms of outsourcing and insourcing?
Ideally, we would like to be able to prepare our VAT returns in-house. However, if we need technical expert opinion, or technical advice, or if we’re short of people, we’ll get people in on secondment from outside. Indeed, we take more external advice now than we’ve ever done before.

Many people who outsource do so to cut costs, so that is the upside. But the downside of centralization and outsourcing is that you lose control, as the service center can be many, many thousands of miles away. The result is months of rework. So how do you mitigate against those risks? The answer is centralizing what makes sense to centralize.

We need centralized tools, but local delivery. Our whole strategy is to build a central platform that is scalable, that can provide the same service across any country in the world. You can’t do this locally. However, people in Singapore are going to know Singapore much better than somebody sitting in Ireland or the UK – so local language, local culture, dealing with local audits, knowing when things change locally – it’s critical that you do that locally. We are developing a central tool, but we have local teams, local operations teams and local technical teams that provide the services locally.

We’re fortunate that, because we’re so large, we have the critical mass to enable us to do this on a local basis, whereas in some cases we may need to have a regional hub; for example, in certain parts of Asia.

To what extent do you think indirect tax is becoming a board-level issue today?
Well, I think it should only become a board issue if something’s gone wrong. If you’re doing the right things and you’ve got the right tools and processes and the right people, it shouldn’t be a board issue. In fact, I would put it the other way round and ask: Is indirect tax increasingly becoming a government issue? And the answer is: yes. Look, for example, at the UK. There have been some abusive avoidance schemes in the UK over the years. Most advisers have left these behind them, but as a result, the tax authority has increasingly been addressing boards about controls and processes, asking: “Is this the kind of thing that you want your business to be seen to be doing?” They’re trying to change behavior at a board level by changing board attitudes."
A coming-together over trade

How a rising number of customs unions and other trade agreements are affecting imports and exports.

Summit of the Gulf Cooperation Council (GCC) in Saudi Arabia in 2011. Many countries in the Middle East and North Africa are members either of the GCC or the Arab Customs Union.
From north to south, governments everywhere have signed up to trade agreements of one sort or another in the hope that their economies will benefit. At the last count, there were 300 or so preferential trade agreements in force between countries around the world. That amounts, on average, to no fewer than 13 pacts for each member nation of the World Trade Organization (WTO). Indeed, successive waves of treaties have seen the formation not just of a union in Europe, but a host of others covering parts of North America, Latin America, Africa, the Middle East and Asia.

Why the rush to link up? Partly, this simply reflects the shift in the balance of the world economy. As Pascal Lamy, Director-General of the WTO, recently noted, the share of global GDP contributed by developing economies has jumped from just over one-third to nearly one-half since the turn of the century. In part, it also reflects the quadrupling in export volumes during the past three decades, much of it from China and the rest of Asia.

Trade pacts are not new. Ever since the Cobden-Chevalier Treaty in 1860 between Britain and France, governments have sought, for a mixture of political and economic reasons, to favor one or more trading partners over another. The difference today is that the proliferation of agreements has become almost self-fulfilling: the more there are, the more that nations jostle to do another deal. Even though the Doha round of world-trade talks stalled in 2008, the fact that Japan is pushing for a Trans-Pacific Partnership could give such deals even more momentum.

Free trade agreements currently account for about 85% of trade deals tracked by the WTO, whereas customs unions are more rare, largely because they tend to involve more countries and are tougher to set up (see “Joining the union” on next page). The four main customs unions in Latin America encompass almost all the region’s economies. Those planned, or up and running, for sub-Saharan Africa, take in virtually every country in the region. And many countries in the Middle East and North Africa are members either of the Gulf Cooperation Council or the Arab Customs Union.

Common tariffs to outsiders
Since customs and excise duties still account for up to half of some countries’ total revenues, particularly in Africa, steps to establish a customs union are not taken lightly. Christina Horckmans, an executive director for indirect tax and a strategic trade advisor with Ernst & Young, until recently in Johannesburg and now in Brussels, notes that it is often the strongest or largest member that benefits most from a customs union. Being in the right place geographically and having a port that acts as a gateway to the union can encourage foreign investment and so boost trade.

“These countries often collect the majority of income from customs duties, which is where discussions may arise about a fair distribution of the income between the various members of the union,” she says. Indeed, for many years, this has been a talking point within the Southern African Customs Union (SACU), of which South Africa is by far the biggest member.

Some groups, such as the Caribbean Community and Common Market (CARICOM), form customs unions as a way to pool their markets, coordinate their policies on trade and give them clout with the rest of the world. Others do so in order to reduce what is known as deflection. This can occur when countries gather together under a simple free trade agreement. Since the tariffs charged to non-members may vary from country to country, importers tend to ship their goods into the one with the lowest tariffs and then transfer them elsewhere within the group. If nothing else, this is inefficient and distorts trade.

Winners as well as losers
In every trade agreement, of course, there are winners and losers. Frank de Meijer, a leader in the São Paolo office of Ernst & Young Terco and
a specialist in customs and international trade, points out that trade agreements will often lead manufacturers to consolidate production in a single country. This usually means that smaller factories in smaller countries lose out to larger ones in countries with bigger domestic markets.

This has worked well for manufacturers in a country such as Mexico. By opening its market under the North American Free Trade Agreement (NAFTA), Mexico has become a base from which carmakers export worldwide. Brazil, on the other hand, has concentrated on its domestic market. Only 540,000 of the 3.4m vehicles manufactured there in 2011 were exported, most of them to Argentina, which is a fellow member of the region’s Mercosur trade agreement. With the value of Brazil’s Real higher than the government would like, and other costs draining manufacturers’ resources, the country has struggled of late to remain competitive as an exporter.

Ironically, too, trade agreements can sometimes do the opposite of what they were intended for. Companies, says Horckmans, expect there to be no formalities or delays at border posts within customs unions. But, because of other taxes such as VAT and excise duties, it can take just as long to clear goods.

“Whether the customs union works to the advantage of companies largely depends on the level of harmonization of all these procedures within the customs unions,” she says.

Some customs unions also have teething troubles. Galina Dontsova, a senior manager for customs and international trade with Ernst & Young in Moscow, says that the customs union between Russia, Belarus and Kazakhstan, introduced less than two years ago, contains a principle of residence. Under this, only a resident of a country member has the right to clear goods into the country. As well as hampering trade in some instances, the rule has led companies to open branches in the other countries within the union.

Indeed, far from reducing the workload for firms operating within them, free trade agreements often increase the bureaucracy. “The Latin America region creates many opportunities as a big market with more than 400m people. However, the burden of compliance is high. The authorities, on average, take longer to process things than in mature markets. Companies must set up bigger back offices to support the complex operation,” says de Meijer.

Chris Horckmans agrees. “The main concern about tax for companies operating in Africa is the lack of certainty and predictability. Companies are willing to comply with the rules and regulations, but they can only do so if the rules are clear and consistently applied, particularly within the region. These include the core elements determining the duty rate, whether or not goods qualify for a preferential rate between trade blocs and the overall cost,” she says.

In emerging market regions such as Africa, where duties are high, such costs can have a big impact on a company’s trading margins. Changes to tariffs can lead to distortions, too. Since Russia’s accession to the WTO, says Dontsova, the duty payable on some components imported into the country has risen to a point where it is higher than that for finished products. Components imported for domestic consumption escape duty, but firms must first apply to the government in Moscow for their products to be listed as such.

**Competition to the fore**

There are some hopeful signs, though. In a world of elongated supply chains and rising levels of trade, competition alone should help to reduce bureaucracy within customs unions. Companies will simply migrate to the place offering the best service or the one that is most “user-friendly,” argues Horckmans. Other nations within a union will then have to ensure their competitiveness or risk losing out.

Nor are such notions lost on the WTO’s Pascal Lamy. Not only does he worry that the rules of origin, which protect so many preferential trade agreements, risk stifling trade, particularly since the distinction between goods and services has blurred. He is also concerned that obstacles to trade, often at an early stage in a manufacturing chain, could have effects on business further down the line. If you cannot get the components, then you cannot build a car.
Deal-makers
under fire

Indirect tax is becoming a key source of risk in mergers & acquisitions (M&A) transactions and may mean the difference between deal success or failure.

“HMRC is now far more aggressive,” says Tony Bullock, a VAT partner in Ernst & Young’s transaction tax team in the UK, who warns that addressing indirect tax issues must now be a real priority during any deal process. “Remember that VAT is a tax on turnover, not profit, so it can be a really big cost - 40% of all the money going through the business.”

Nor is this solely a UK problem. Bart Van Renne, senior VAT and customs manager for Europe at Stanley Black & Decker, says that indirect tax issues are rising up the agenda across the European Union. “Administrations and governments recognize that there’s a great deal of money to be made from VAT,” he says.

At Stanley Black & Decker, which has completed more than 60 M&A transactions since 2000, indirect tax has become a key part of the due diligence process. The European Union’s disparate indirect tax regime, with different rates and rules in every Member State, magnifies the complexity. “We’ve had to instill a greater focus within the company on this and get to a better understanding of potential problems,” says Van Renne. “Indirect tax is now very much on our list during a deal - it’s a core issue.”

Acquirer due diligence of indirect tax issues is essential in order to prevent an unexpected tax liability for the purchaser once the deal is done - possibly several years later. Common mistakes include failing to ensure VAT group administration has been arranged correctly, particularly where companies are multinational. Any recent property transactions will need to be particularly closely scrutinized, since this is another frequent cause of difficulty.

If problems do emerge, the way in which they are treated will vary from one side of the deal to the other. “On the sell side, if there is an issue, it

By David Prosser

Any company that embarks on an M&A transaction understands that there is a long list of potential pitfalls that can derail the deal, from overpaying for assets to battling with cultural integration. Until recently, however, few executives would have placed difficulties related to indirect tax high on that list. But according to Ernst & Young’s recent survey of the role of tax in M&A, this is changing. The research found that 65% of companies say that indirect tax planning is now a primary or important component of transaction value.

So what has changed? In the past, VAT was typically regarded as a cash-flow issue rather than a cost. Companies expected to be able to reclaim VAT paid ahead of an M&A transaction by either party, whether the tax was charged on spending related to the deal itself, or as part of the company’s normal business activities. This is no longer the case in some jurisdictions, because tax administrations have become much tougher about the way they look at VAT during and after M&A transactions, even resorting to litigation with increasing frequency.

Tougher treatment

The UK is typical of this shift. The penalties on unpaid VAT can be up to 30% of the liability in cases where an error is judged to be careless, rising to as much as 100% if HM Revenue and Customs (HMRC), the UK tax administration, says there was a deliberate attempt to avoid paying. An increase in the VAT rate, from 17.5% to 20%, along with an extension of the period over which HMRC has the right to challenge a VAT return from three to four years, have also focused minds on this issue.

“HMRC is now far more aggressive,” says Tony Bullock, a VAT partner in Ernst & Young’s transaction tax team in the UK, who warns that addressing indirect tax issues must now be a real priority during any deal process. “Remember that VAT is a tax on turnover, not profit, so it can be a really big cost - 40% of all the money going through the business.”

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If problems do emerge, the way in which they are treated will vary from one side of the deal to the other. “On the sell side, if there is an issue, it
can be presented as one that is receiving attention and being fixed,” says Bullock. “On the buy side, the same issue is looked at from a worst-case scenario perspective – the size of the potential tax bill and penalties, but also the cost of management time spent on this.”

From a buyer’s perspective, the hours needed to resolve a potential VAT problem are likely to jeopardize the deal timelines. And, depending on the scale of the issue, the theoretical liability might even put the economic viability of the transaction at risk. “Often, in the current environment, the acquiring business will be stretched financially and may be right at the limits of its banking covenant,” says Bullock. “This means that there simply may not be the headroom to deal with an additional VAT liability.”

Equally, however, some sellers might argue that the buyer is exaggerating the significance of the problem in order to drive a harder bargain. “Buyers do use VAT issues tactically – to reduce the price, for example, or to try to secure a better deal in some other way, such as the provision of post-deal assistance,” says Bullock.

Either way, the potential for a VAT problem to destroy value, in the event of the business being sold, underlines the importance of good administration on an ongoing basis. Companies that take their corporate governance standards may be bureaucratic, time-consuming reporting regimes in other countries, where the controls may also be an issue. It is not just that certain types of goods may only be exported with the express permission of HMRC, but also that certain types of activity expose businesses to reporting regimes in other countries, where the standards may be bureaucratic, time-consuming and expensive.

### Resolving tax disputes

The broader point is that indirect tax has become a much bigger issue than ever for those involved in M&A transactions – on both sides of the deal. Often, the only way to resolve an indirect tax dispute, where the potential liability may be difficult to quantify, is for the seller to offer warranties or indemnities. But those are only valuable as long as the seller remains in business, exposing the purchaser to more risk than originally anticipated at the outset of the deal. Nor is such an arrangement necessarily satisfactory for the seller, which will be required to make provisions for the possibility of having to fulfill those warranties or indemnities.

In such circumstances, there is no clean break following the completion of an M&A transaction, which is often an objective for both sides. Indirect tax concerns may mean continuing a business relationship for longer than was originally anticipated.
In the late 17th century, the Russian Tsar Peter the Great implemented a beard tax, as part of a series of measures to regulate the appearance of his subjects. But it was also an early example of body parts being subject to taxation. Today, in the United States, money received for donating blood and body organs is subject to tax. Case law holds that if the donations are frequent enough, donors may treat this as a business and claim related expenses, such as specialized health food to enrich the blood.
Lists of unusual taxes abound. Typically, such lists are designed to draw humor from levies that show particular inventiveness or greed on the part of governments. However, beyond the laughter lie some basic lessons about what, and how, taxes will be assessed. The following is a rough guide for business:

- **Taxes follow economic activity or assets, no matter how novel or unusual.**
- **Most lists of unusual taxes refer to the Roman Empire’s urine tax.** In context, though, there is little remarkable about it. Collected urine left by users of the city’s baths was a raw material used by a number of industries. A tax on it therefore differs little in concept from that on any other input. The broader lesson of the tax is that governments seeking income are unlikely to leave any material or activity exempt indefinitely and firms should probably plan accordingly. For example, if America’s sales tax exemption on out-of-state internet sales endured as the volume of this activity increased, it would be more of an oddity than a urine tax.
- **Apparent absurdity often reflects an attempt to find a taxable substitute.**

Other common entries on lists of unusual taxes were duties, imposed at various times in England, on the number of windows a house had. Richer homes had more windows, and so this made for a useful - and easy-to-measure - means of gauging the approximate value of a home. In essence, it was a substitute, or proxy measure, for what eventually became a house tax in 1851.

George Harrison’s lyrics describe the use of such proxies clearly, as well as reflecting the common annoyance with it. But these create problems for both governments and tax planners. For example, their apparent simplicity also made tax reduction easier - English house owners, for example, took to bricking in windows, just as Peruvians today often leave parts of their houses incompletely finished, in order to avoid a tax on fully built houses. Today’s tax planners, however, need to be more careful as complying with the letter of the law may not be enough. In recent years the European Court of Justice has supported this approach in its landmark decisions on the “abuse of law” concept.

- **The search for consistency is often the source of the strangest taxes.**
- **The most unusual taxes are often not imposed by legislation but by the courts seeking to interpret the law consistently.** The taxes on income from items such as donated blood and haunted houses are just two such examples. Any company operating in an obscure area that seems to not be subject to tax should be prepared – it almost certainly will be upon closer examination. The good news, though, is that the search for consistency can also allow unexpected deductions. In the United States, for example, the costs of a swimming pool can be treated as medical expenses under certain circumstances, such as if it is purchased on a doctor’s advice.

- **Sin taxes are only bizarre if you don’t think it is a sin.**

Governments have always tried to shape behavior by taxing activities they want to discourage but find hard to criminalize or otherwise deter. As a result, many taxes from previous eras appear strange today because the activities they attack seem perfectly normal now. At the time, however, they were no stranger for people than duties on tobacco appear to us today. The broader lesson for business is to appreciate that, as attitudes change, so might taxes. Today’s efforts to levy taxes on things such as carbon emissions or even fat are a case in point.

Of course, although context can explain many of history’s unusual taxes, there remains scope for creativity. The items depicted on the following pages are just some examples that show how creative officials are willing to become when seeking to fill government coffers.
Wind tax
The Netherlands, around 1800

The weather
In the Netherlands before 1800, millers had to pay ‘windrecht’, a tax on the wind, to the local lord. The latter, in return, would prevent the construction of high buildings or the growth of trees around the miller’s windmill. Today, the Adelaide region in Australia is now on the cusp of imposing a charge on the use of rainwater collected by farmers and then used by them for their own commercial purposes. Meanwhile, Riverside County, California, is imposing an acreage-based fee on solar power facilities – effectively a tax on the sun.
Greater pressure on tax compliance

Multinational companies are coming under increasing pressure to disclose activities of their subsidiaries in every country where they operate, as part of wider pressure by governments to raise revenue. This has growing public support with protestors in particular arguing for greater taxes on banks. Combined with wider protests against government cutbacks, all this has served to raise the issue of tax avoidance in the public consciousness, making it a far more high profile issue.

Playing cards

England taxed playing cards, and dice, from as early as the 16th century, right through to 1960. Other countries followed suit, with the card tax in Austria getting so high at one point that local manufacturers started producing oversized packs that could be trimmed back as the edges got worn to extend their lifespan. The US kept its card tax until 1965, which was paid for by buying stamps of an appropriate value to paste onto the pack. The state of Alabama still retains the tax today, applying a levy of 10 cents on all packs.

Credit: Private collection Peter Endebrock
Window taxes were a major part of life in England, France, the Netherlands and Scotland, leading to many windows being closed up. This wasn’t the only aspect of home design subject to tax. At times, a stamp duty on wallpaper, as well as a fireplace tax, cropped up. But the idea behind this was simple: finding a readily visible item to use to gauge property value. In theory, it should be hard to hide a fireplace, although enough people apparently tried to do so that revenue agents were allowed to enter any dwelling in the country to check for these.
Space commerce

Since passage of the US Tax Reform Act in 1986, any income earned in outer space by American citizens is deemed to have been earned in the United States itself. This has the drawback of removing such revenue’s previous eligibility for use in calculation of foreign tax credits. So far, efforts to reduce the tax burden in space, such as the proposed Zero Gravity, Zero Tax Act of 2001, have failed to secure Congressional approval. Just one more risk for those exploring the final frontier.
Getting serious about Africa

A decade of strong growth has seen Africa come onto the radar of many multinationals seeking new opportunities. But as the political and macroeconomic risks fade, new administrative challenges are emerging.

By Andrew Sawers

Africa has long been written off by business, but a shift is now underway. Ernst & Young forecasts a growth rate of 5.5% in 2012, with foreign direct investment into the continent expected to almost double from US$84b in 2010 to US$150b in 2015.

To capture this opportunity, reform efforts are underway, with the continent’s key economies working to develop a more stable and predictable business environment. Governments are also transforming tax structures and growing the tax base to provide the revenues needed to create more sustainable economies.

Indirect taxes, especially VAT, play a growing part in all this. Two decades ago, only a handful of African countries had introduced VAT, with South Africa (1991), Kenya (1990), Tunisia (1988) and Morocco (1986) standing out as forerunners. The pace of adoption picked up through the 1990s and 2000s. Today, fewer than a dozen African countries have not yet implemented a VAT.

This has steadily shifted the proportion of indirect tax revenue that Africa’s economies collect, from around 2.5% of GDP in sub-Saharan Africa in 1980, to about 5.5% in 2005, according to the IMF. As a share of national income, this remains low, but clearly shows the direction in which it is heading. Furthermore, in lower-income countries without major natural resources, the OECD calculates that indirect taxes can make up around one-third of total tax revenue.

Moreover, while a range of goods and services are currently exempt or zero-rated, the indirect tax net is getting wider. Kenya, for one, is reversing a trend that has seen the list of zero-rated and exempt products gradually expand over the years. By broadening the scope of VAT, its government hopes to take in enough tax revenue to afford to cut its VAT rate.

VAT’s rising popularity

There are two reasons why VAT is proving attractive across the continent. For one thing, it is a relatively easy tax to collect, with the burden of collection pushed onto all companies in the supply chain. Secondly, at least in theory, it has a fairly good compliance record, with reduced scope for evasion.

“Governments are certainly committed as part of their reform programs, and also as part of the IMF and World Bank programs, to develop better fiscal revenue machinery, particularly taxation,” says Pratibha Thaker, Regional Director for Africa at the Economist Intelligence Unit (EIU). Indirect taxes in particular are part of this reform agenda. As one example, Egypt expects to replace its current sales tax with a VAT system, at the behest of the IMF.

Summary

Over the past decade, Africa has become a market of rising importance to multinationals looking for growth. But the traditional macroeconomic risks faced are now evolving into administrative ones, such as on tax.
Etienne Louw
— Head of Group Tax at
Absa Group, South Africa

Rudi Grobbelaar
— Absa’s Head of Indirect Taxes
Focus / Africa

Just as importantly, Africa needs to grow its indirect tax base so as to reduce its reliance on highly volatile revenue streams from fluctuating commodity and mineral prices. Similarly, the continent’s ongoing shift toward ever-greater trade liberalization is reducing the tax take from excise duties and tariffs. As a 2009 IMF report on revenue mobilization in sub-Saharan Africa describes it, “A shift towards consumption taxation [in sub-Saharan Africa] thus appears to provide a simple strategy for recovering revenue without jeopardizing the welfare gain from trade liberalization itself.”

Contradictory laws
But there are problems, and these affect businesses of all sizes and sectors operating in Africa. Chief among them, arguably, is the plethora of jurisdictions. As the OECD highlights in its international VAT/GST guidelines, this can result in multinational businesses being confronted with contradictory laws and administrative requirements from one country to another. In turn, this results in undue burdens, uncertainties and double taxation. It can also disrupt corporate efforts to create shared tax service centers serving several African countries.

Charl Niemand, Partner for Indirect Tax Africa at Ernst & Young in Johannesburg, says that there is a lot of simplification that could be introduced. In particular, the “place of supply” rules, which determine the jurisdiction in which goods or services are delivered and hence where the trade is subject to VAT, need to be fixed.

A related issue is simply the lack of certainty in many places. This can be as basic as the fact that, as in the case of the Democratic Republic of Congo, which has just introduced VAT, the statute isn’t easily available. “The area where you can make the quickest progress is to release guidelines and interpretation notes and rulings – all the explanatory memorandums that aren’t in legislation,” Niemand says. “Guidelines really give the taxpayer a fair chance to get things right. But in the absence of those guides, you never know whether you’re right or wrong.”

Much of this is due to a lack of skills and experience across these countries. “It goes hand in hand with the quality of the labor market,” says Thaker. “It’s really very much dependent on the quality of education and training. If one key criterion is missing, the other will not happen overnight. It is going to take a decade to develop.”

This lack of harmony and even the lack of basic tools and skills are issues that the Africa Tax Administration Forum (ATAF) is trying to address. The body was established in 2009 and now has 34 countries in its membership. It not only shares ideas on emerging tax issues or best practice in administration, but is also discussing how to share information about taxpayers between various tax authorities. As part of the response to the skills gap, some governments are setting up specialist Large Corporates Offices (LCOs) within their revenue authorities. Such offices already exist in South Africa, with others being set up. The idea is that these are staffed with the most skilled tax officials to deal with the most complicated tax issues being handled by the largest taxpayers. These will also equip tax authorities with the ability to target companies more directly, with the necessary skills to do so effectively.

This highlights the changing situation faced by multinationals on the ground, as the tax net is widened, but often with new issues emerging along the way. One trap to watch out for is that many African countries do not make cash refunds in VAT refund situations, which is where companies don’t collect more VAT on their sales or supplies than they pay on their purchases. Instead, authorities simply allow an offset in subsequent periods. This effectively means that the money might not be seen again, “or you might wait years before your amount is actually refunded,” explains Rudi Grobbelaar, Head of Indirect Taxes at Absa, a South African banking group.

From a government perspective, the rationale here is twofold. One is that the prevalence of fraudulent claims is often a major reason for delaying payment of refunds. Another is that less-advanced tax administrations often pursue time-consuming processes to verify claims before approving refunds. Kenya has been struggling with a US$177m backlog of VAT refunds, which the government hopes to address with its VAT simplification program.

Putting the right systems in place
For a multinational seeking to operate and thrive across African markets, all this makes good systems critical. “If you don’t have visibility of your indirect tax value under management then you don’t know what you’re managing,” says Niemand. “For indirect taxes and customs there are a lot of details required. You need to know are you using the right tariffs codes - do you have exceptions, variances, those sorts of things. People just don’t have those systems.”

The need for such systems is most apparent in South Africa, the continent’s largest economy. The South African Revenue Service, or SARS, has steadily developed its own systems and sophistication, with growing demands on corporates as a result. This is a clear risk for those that are not sufficiently prepared. “They’re requesting data from companies, interrogating this and then asking the firms to respond to the outcomes,” Niemand says.

“We have done a lot of work to develop and incorporate a number of system, reconciliation, verification and other controls, including SOX (Sarbanes Oxley) controls, new product approval processes and implementation reviews in our tax risk framework,” says Etienne Louw, Head of Group Tax at Absa. “If you look at the sum of our

20%
The current standard rate of VAT is 20% in Morocco, 16% in Kenya, 14% in South Africa and 5% in Nigeria.
input taxes and output taxes which we have to manage, it's quite a significant amount - far in excess of our corporate tax charge. In many African countries the combined effect of high reverse VAT charges and withholding taxes is substantial, often exceeding the pre-tax profit of certain transactions," he says. Grobbelaar adds that the key factor is the ability to rely on systems, controls, processes and procedures. "As far as possible, considering the large volumes of transactions and sometimes complicated legislation, you need to automate and document the processes to make sure that human intervention is kept to the bare minimum and all risks are properly managed. You also need to continuously train people," he says.

Going local
This strong focus on controls backed by regular implementation reviews and a transparent approach also helps lead to a better working relationship with SARS, giving Absa greater authority in any technical discussions with the tax authorities. "We pick up an error in one of our reviews and we go to SARS and say, 'Here's a payment.' They appreciate that approach. But the reviews go both ways and are mostly to our benefit. This makes implementation reviews an important part of our tax risk framework," says Louw. Getting this kind of approach right, however, requires a local presence. This is partly due to having to more closely manage less sophisticated tax authorities in many jurisdictions, but also to watch out for various specific risks—possible withholding taxes on management fees, for example, or reverse VAT. All this makes it more challenging to set up regional shared service centers, as many multinationals are doing in other regions. "You need expert local knowledge on those countries as well," says Grobbelaar. "It's a transactional tax and you rely inter alia on systems and external advice where necessary, as legislation and practices differ in each country."

Furthermore, given the skills challenge faced across the continent, Niemand advises firms to think very carefully about who looks after such issues internally. "Indirect taxes often constitute quite a significant value in a company if you get it wrong. But you then want to go to a person who is responsible for the mistake. From a governance perspective I think indirect taxes are not put in the right place. Often it is a very junior person managing the process. Yet often the risk - the indirect tax under management - is more than a company's earnings before interest and tax," he notes. As multinationals start to take Africa's promising emerging markets more seriously, closer management of their indirect tax systems will also be needed.

Eco-friendly and futuristic: the Absa Group’s head office building in Johannesburg.

About Absa
The Absa Group Limited (Absa) is one of South Africa’s largest financial services groups offering a complete range of retail, business, corporate and investment banking, insurance, and wealth management products and services. At 31 December 2011, the Group had assets of R786.7bn, 12.1m customers and 35.200 permanent employees. Absa is a subsidiary of Barclays Bank PLC, which holds a stake of 55.5% in the Group.
Unilever’s indirect tax management challenge

Effectively managing indirect tax requirements in a global marketplace calls for a deeper consideration of how corporate processes, systems and skills need to change and adapt.

By Phil Davis

Under the designation of indirect taxes, there are a wide variety of taxes levied, including value added tax (VAT), goods and services taxes (GST) and customs duties. In addition, governments are increasingly looking at particular local indirect taxes, such as food and environmental taxes to promote certain preferred behavior. While indirect taxes are proliferating across the globe, there is not much uniformity in how they are implemented, in particular outside Europe. Each country has its own rules about how, when and where tax is charged, and the related documentary and reporting requirements vary widely.

As companies refocus their sourcing and sales activities toward emerging markets, particularly the BRIC countries, this only serves to increase the challenges. Rishi Gainda, Director Global Indirect Taxation at Unilever, says: “Brazil and India, for instance, have complex indirect tax regimes which are not similar to those in Europe.” Meanwhile the current indirect tax system in China does not exist in a form recognizable to many European companies, but it is likely to do so during the next few years. “A VAT pilot is being launched in Shanghai as a groundbreaking step to reforming the indirect tax system in China,” Gainda says.

While the indirect tax challenges are significant, overcoming them does not only ensure compliance, but can enhance the standing of a business, reduce tax penalties and improve cash flow and revenues. “Managing indirect tax is very challenging, particularly in emerging markets,” says Gainda. “But doing it properly can differentiate your company from competitors.”

Indirect tax models called into question

The indirect tax burden on multinational companies inevitably grows in line with the size of the business and its revenue trajectory. Unilever is a case in point. With 171,000 staff and turnover of €46b derived from sales in more than 190 countries, the scale of the challenge is considerable. “With this amount of turnover, the indirect tax throughput is massive,” says Gainda. In 2009, an internal survey revealed an indirect tax throughput of €12b-13b. “Given the growth of the business, this figure has increased since then and will do so even more in the next few years,” Gainda adds. “This has considerable impact on working capital and cash flows.”

The growth of international business and the mushrooming of indirect tax regimes are combining to call corporate models of tax management into question. Companies are starting to reexamine whether they have the resources and skills to effectively become tax collectors on behalf of governments. As Gainda notes: “There is a global trend for governments to increase revenues through indirect taxes by both increasing VAT rates and broadening the VAT taxable base. Governments often tend to think that VAT is relatively easy to levy because companies act as tax collectors.”

There is little reward for efficient tax collection, but stiff penalties for failure. Compliance with indirect tax regimes is critical because taxpayers falling foul of them can incur a penalty, as well as suffer retrospective tax assessments and a loss of reputation. At the same time, indirect taxes can provide opportunities for companies with vigilant and proactive indirect tax functions. Gainda says the growing trend of levying or increasing indirect taxes on unhealthy foods, for example, could be a stimulus for a company manufacturing food products to revisit its product portfolio. “If there are taxes on foods with high sugar or salt concentrations, companies in that sector may develop low-sugar or low-salt products that meet the standards at competitive prices. This could also support a wider business goal of developing healthier products.”

The same principle and solution can be applied where green taxes are levied. Gainda notes that Unilever’s vision is to double the size of its business while reducing its environmental impact. By properly managing green taxes there will not only be a positive financial impact but it could support Unilever’s commitment to reduce its environmental impact. This demonstrates that indirect tax teams can do considerably more
Lipton tea, one of Unilever’s most widely recognized global brands, is available in over 110 countries, from Asia to the Americas.

than manage indirect tax risks and VAT compliance. As well as optimizing cash flow, which helps the company’s funding needs, indirect tax specialists can help develop or further strategic aims. “We should use indirect tax to support business priorities,” says Gainda. “In that sense, indirect tax can be a true partner to the business.”

End of the silo?
There is growing recognition that, to manage the risks and take advantage of opportunities, the indirect tax management structure must reflect the impact across all of a company’s activities from sourcing to sales.

Of course, only those indirect tax specialists with experience and relevant skills will be able to ask the right questions and make the leaps of understanding required to create useful links with the key business units. These people are thin on the ground. “You need to have talented people specialized in indirect tax and you also need to have them in the right place” in order to partner with the business effectively, says Gainda. “Traditionally, Europe has had a large pool of indirect tax specialists. But this seems less true of Asia and even less so in Latin America. This is where the people challenges lie, particularly given the growth of business and the changing indirect tax systems in these regions.”

While communications and human resources are important elements for companies to assess and control their indirect tax risks, technology also has a critical role to play. Many multinationals have implemented enterprise and resource planning (ERP) systems and are now deciding whether to update them or add costly advanced indirect tax functionality to deal with growing tax complexity.

In addition to dedicated indirect tax resources and advanced indirect tax technology, Gainda cites a third key enabler for optimizing the indirect tax function as a valuable business partner: managing indirect tax via a comprehensive indirect tax control framework. Unilever is currently working on a project to review its indirect tax compliance processes and build an indirect tax control framework. The framework outlines the processes, including indirect tax risks and controls, and shares information about how indirect taxes can be managed effectively. In addition to indirect tax compliance processes, there is a link to other business processes that are impacted by indirect tax. “The framework will also address how the indirect tax function should get involved in business change and how it adds value to the business as a whole,” says Gainda. 

Rishi Gainda
Based out of the Netherlands, he is Director for Global Indirect Taxation at Unilever, responsible for managing the company’s indirect tax workstream and strategy.
Navigating indirect tax

Marina Wyatt, Chief Financial Officer of TomTom, the world’s leading supplier of in-car location and navigation products and services, talks to T Magazine about her company’s approach to indirect taxes.

Interview by Phil Davis

T Magazine: How is the global move toward increased indirect taxes affecting your company overall?
Marina Wyatt: The trend today is clearly away from corporate tax and toward raising revenues from VAT. Customs duty also continues to be a major topic. Since we are selling consumer electronics goods, these issues have an impact on our business strategy, particularly on pricing. In general, retailers can’t pass on increases in VAT to customers and yet prices tend to fall when VAT goes down. There is little you can do in this respect and we share the pain with retailers. But there are other ways in which we are impacted, such as the need to regularly update our systems with different tax rates, which entails a lot of work.

Do you have a discrete indirect tax team to deal with this increasing burden?
We do have people who are specialized in indirect tax within the tax function, and we automate as much as possible. While some of the work has been moved to our financial shared service center, the indirect tax team carries out the specialist work.

How do you keep tabs on changes to indirect tax regimes around the world?
Our tax team is very proactive. They talk to their advisors regularly and expect their advisors to be proactive too. It is critical for the tax team to have close relationships with the business units so they can inform us about relevant developments. To do this, we have regular, informal meetings with our heads of departments. Meetings are face to face, via conference calls, by telephone and we also have video over IP on our computers so the whole company is networked. It’s easy, you don’t have to set up a video conference if you want to talk to someone by video.

To what extent is indirect tax a consideration in your key business areas?
Indirect tax should be a key consideration when launching new products and pricing has to be planned on a basis that includes indirect tax. This is a big issue when doing business in countries such as India, for instance, which has very high customs duties compared with European countries. That is a real challenge when planning in different regions. So when we launch new products, various departments, including the tax function, all look into the potential profitability of the product.

Could you give an example of how your shared service center for tax has added value to the business?
Our shared service center was able to help with the tax migration issues after the acquisition of Tele Atlas in 2008. We took immediate control of the acquired company’s tax affairs and centralized them without the need to expand our tax team. We were able to keep compliant with all the indirect tax even after we had bought in a different type of product.

How have you reacted to the greater need for tax compliance and to increasing aggression by many tax authorities?
Above all, we need to be compliant. The key to this is to have the right governance and competencies in the company. I have Board level responsibility for the tax area so it needs to be set up in the right way to give the other directors comfort.
Indirect tax can have a significant bearing on a company’s sales and profitability, but close relationships between tax teams and the rest of the business are rarely found. This needs to change.

By David Bolchover

Indirect tax can have a significant bearing on profits, but business managers often underestimate its importance in the rush to launch new products or expand into new territories, leading to wildly inaccurate sales projections. A strong relationship between these managers and indirect tax experts, either within or outside the company, can therefore lead to more prudent and measured commercial decision-making.

Determining what the indirect tax rate is for a particular product is the first issue businesses have to navigate. In the UK, the standard VAT rate is 20%, but then there is a reduced rate of 5%, a zero rate (where no VAT is charged but the seller can still recover its input tax, or the VAT that it incurs on its own purchases) and there are VAT exemptions (where no VAT is charged but the seller cannot recover its input tax).

Products can’t necessarily be placed neatly into categories; they can have different VAT rates depending on the form in which they are sold, and may have different elements, some of which carry VAT charges and some of which don’t. For example, paper books are zero-rated in the UK, but electronic versions of the same book...
are not. The European Commission is currently investigating the VAT treatment of e-books for the whole of the EU, but is struggling with this issue.

International variations in VAT treatments further complicate this. Even within the EU, member states can apply very different rates to the same product. “There is often a conflict between national legislation and EU legislation on VAT treatment for a particular product,” says Richard Teather, Senior Lecturer in Tax Law at the UK’s Bournemouth University. “This is complicated enough when you just have to deal with one country. But of course you have to bear in mind that this complexity is replicated for each of the member countries.” Expansion outside the EU becomes tougher still for companies trying to factor all this into their planning.

**Business implications**

As the relevant level of indirect tax will influence a customer’s ability to buy a product, it will clearly impact on a company’s sales and profits. Firms therefore have to determine the ideal price to maximize revenue while still complying with legislation.

“If companies don’t factor VAT costs into their pricing of a product, then their eventual results are going to look very different from original forecasts,” says Andrew Bailey, a leader at Ernst & Young who specializes in VAT issues in the financial services industry.

Failure to comply with legislation can lead to substantial retrospective payments to the tax authorities, with potentially disastrous consequences for smaller, more vulnerable companies. Several years ago, Debenhams and some other retailers in the UK introduced a VAT-exempt card-handling fee of 2.5% of the value of goods paid by customers, but prices were nevertheless the same, no matter whether the customer paid by cash or card. In 2005, the courts eventually ruled that Debenhams would have to pay VAT on that 2.5% because the card-handling fee was introduced “in order to produce a position whereby less VAT is paid than was paid previously and for no other reason.”

Without ongoing specialist advice on what is a constantly changing legislative environment, such misjudgments are inevitable. “Business managers are often operating at great speed in a highly competitive marketplace,” Teather explains. “The tax department might intervene only after the deal has been done. In small companies that don’t have a tax department, external accountants may only review their operations after the year-end when the damage has already been done. Without tax specialists who are fully integrated and embedded in the business, it becomes extremely difficult to understand the full implications of all the complexities of VAT.”

Moreover, only the largest companies tend to employ experts focused solely on indirect tax.

Several years ago, the British retailer Debenhams introduced a VAT-exempt card-handling fee of 2.5% of the value of goods paid by customers.

**A key source of risk**

Ernst & Young’s 2011-2012 survey on tax risk and controversy shows tax administrators and taxpayers view indirect taxes as a key source of risk in the coming one- and three-year periods. Tax administrators all over the world are putting a stronger focus on enforcing indirect tax compliance.
But with the sheer quantity and complexity of indirect tax legislation continuing to grow at such a rapid pace, even tax generalists may find it ever more challenging to keep abreast of developments, leading to potential problems. “Dealing with indirect tax can be like speaking in a foreign language, even for accountants and general tax advisors,” says Bailey. “They should have processes in place so that they know when to seek specialist advice. Without that input, they will undoubtedly make errors.”

At a high level, ensuring seamless integration of tax issues into the business strategy requires board-level intervention. However, despite the risk that VAT can pose to the bottom line, it often does not figure in the minds of directors. Andreas Funke, at Ernst & Young’s indirect tax practice in Germany, says board-level interest is usually only aroused when there is likelihood of a loss being sustained. “When indirect tax impacts the bottom line, it makes it to the boardroom but it might be too late by then,” says Funke. “I’ve seen cases where the sales department entered into a transaction, calculated a margin of 10% but then the VAT wiped out the entire margin.”

**Increased focus**

But there is a growing mindfulness within the corporate world about the dangers of downplaying the importance of indirect tax. One industry that pays particular attention to indirect tax is financial services. Products are generally exempt, and companies therefore need to examine in great detail how to maximize their input tax recovery.

“There is a great deal of awareness in our company,” says Michel Voets, Senior Indirect Tax Adviser at ING, a bank headquartered in the Netherlands. “For most companies in other industries, indirect tax is principally a plus-minus situation, charging VAT on their supplies, but getting it back on their purchases. But if we incur VAT in a VAT-exempt environment, it’s mainly a cost to us.”

Companies in other industries who are now just beginning to focus more on the VAT implications of their commercial operations can perhaps therefore learn from the experience of financial services companies about how best to organize themselves internally to make their planning as effective as possible.

According to Bailey, companies in banking and capital markets generally have a committee that will look at new products and ventures into new territories. Various functions, including tax, are represented, and all must give their approval before any launch can take place.

Of course, as VAT legislation is constantly evolving, such an approval might need to be reassessed further down the line. “As soon as we see new laws, proposed legislation or published case law, we have to assess how different units are impacted, and whether to change an individual product or its pricing,” says Voets. “If a product goes from exempt to taxable, for example, and we decide that we can’t raise prices because of a competitive market, we have to discuss whether to swallow the cost ourselves.”

ING also pays attention to offshoring and outsourcing projects, as well as major purchases by its procurement division to ensure that they are carried out in a tax-efficient way.

**Building relationships**

Perhaps an even greater threat to the company than changing legislation comes when business managers decide unilaterally to amend an already approved product or launch it in a new territory without fully understanding the indirect tax consequences. Advisors must thereby communicate with frontline departments on a constant basis. “Business managers can think, ‘I’ve got a sign-off, so there’s no need to do anything,’” says Bailey. “The onus is on the indirect tax department to find out what’s going on. You can’t be a passive background figure; you have to build relationships with the business.”

To do so, indirect tax experts have to demonstrate that they understand their everyday priorities and pressures. “We need people to feel comfortable with us as a fully accepted business partner and trusted and respected advisor,” says Voets. “We must give them proper tax and commercial advice, explain that we can improve the financial performance of their department by making them more tax-efficient.”

Voets believes that indirect tax advisors can establish credibility by developing their industry knowledge and their understanding of how complex products work so that they can converse fluently in the language of the overall business. To that end, ING sends its tax experts on internal courses to learn about particular business areas within the finance industry.

However, even in financial services, where indirect tax specialists are likely to be employed, finding out exactly what is going on in a large organization will always present a challenge. Bailey believes that the most effective indirect tax managers treat the broader business as if they were dealing with a large client company: “You need to find out who the decision-makers are, who the influencers are, who can help you do your job. For example, build a relationship with the head of legal and tax generalists within the company, and educate them sufficiently so that they can alert you to relevant developments in the business which you may well not yet know about.”

In other words, indirect tax advisors cannot afford to wait to be invited into discussions that could affect the company’s VAT position. They must constantly be developing contacts and using their instincts to avert problems. Even if the company has access to the best indirect tax advice available, it may well not have the desired impact if it is not fully integrated.
Europe's failing VAT system

The EU VAT system is in a mess. It is a dizzying mix of rates with a huge number of exemptions and special cases across its 27 countries. The VAT gap is now a stunning €100b, which is steadily rising due to fraud resulting from the fact that there is no taxation on EU cross-border purchases by businesses. At the same time, companies, which effectively act as unpaid tax collectors, are facing a growing compliance burden. While governments agree they should reduce such costs and obligations, many are adding more compliance obligations and implementing disproportional sanctions, as they increasingly rely on VAT to help plug their fiscal gaps.

It is a bad combination: endemic fraud, an increased compliance burden, disproportional sanctions, and an increasing reliance on VAT as a source of revenue. In turn, this has serious economic and financial consequences, with a large, but unpredictable, impact on competition.

Europe's current VAT system was meant to be a transitional one, but there are no signs of any alternative emerging. Indeed, most European governments are dragging their feet and don't seem to want to do anything to get to the root of the problem. The popular solution right now essentially involves putting a sticking plaster onto the problem, by simply seeking to increase VAT rates, rather than fixing the underlying system.

There is no doubt that tax harmonization is an important goal. We need to have a VAT that suits an internal market, with a single rate across the community. This should ideally do away with multiple rates across Member States. But such a move seems unfeasible, not least due to legislation needing to be accepted unanimously by all 27 members. It also seems to be the case that the EU is not willing to take the final consequences of what a true internal market implies, which is one that makes no distinction between domestic sales and sales to the rest of the internal market. Until that recognition is made, we will only ever get stopgap solutions.

The European Commission has had all kinds of ideas to deal with these VAT problems, but these focus more on politically realistic solutions rather than on ones that would repair the situation. The results are not only costly, but also simply not what business needs. As one example, the Commission is looking at “a one-stop shop” system for VAT, allowing companies to account for VAT due in all Member States via a central website, a portal, in their home country. This sounds very practical, but in reality will be hugely difficult, given that a business operating in all 27 Member States will still need to know the different rules for each state – from different invoice rules and rates, through to different exemptions and varying sanctions. It does nothing to resolve the underlying issues within the system.

A lot could be learnt from outside the EU. Take New Zealand, which has a simple and effective VAT system, with virtually no VAT gap as a result. It has one rate, few exemptions, and compliance is very simple. There are other good VAT systems in Australia, Canada and South Africa, too.

So we can see what a top-class VAT system should look like. Moreover, a perfect solution to today's fragmented system has long been proposed. This would allow charging domestic VAT to all economic operators in the EU and provide for centralized multilateral clearing between Member States. The system is very straightforward, especially when it is understood that 60% of the trade in Europe is conducted between related parties and there is therefore no reason to charge VAT on cross-border transactions between pan-European groups.

But this idea has been ignored. Underlying all this is a fundamental unwillingness of national governments within the EU to agree to a proper solution. There is a lot of distrust right now, with little sign of any real solutions emerging. The OECD understands that the system needs to be overhauled and they have, for example, agreed on guidelines of neutrality in VAT and GST. But it is not able to force through any direct change by itself.

All this is a pessimistic message. I'm a genuinely optimistic person, but it is hard to see light in the tunnel with regards to Europe and VAT right now. Notwithstanding the gravity of the situation, few politicians appear to have the will to deal with this problem. What will be needed is a change of attitudes within Member States and for leaders to find a new resolve to deal with VAT problems. Let's just hope it doesn't come too late.

Ben Terra,  
Professor of law at Amsterdam and Lund Universities

Biography  
Ben Terra is a professor of law at the Universities of Amsterdam in the Netherlands and Lund in Sweden. Until 2003, he was Head of Ernst & Young's global indirect tax practice. In 2007, he became doctor economiae honoris causa at the University of Lund.
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Ben Terra教授于阿姆斯特丹大学学习国际法，于莱顿大学学习间接税法。他曾出任设于海牙的荷兰财政部增值税、关税和消费税研究生培训项目的负责人，也担任莱顿大学教授，佛罗里达大学（盖恩斯维尔市校区）、澳大利亚悉尼大学和其他院校的客座教授。目前，他是荷兰阿姆斯特丹大学和瑞典隆德大学的法学教授。他发表了许多关于间接税的文章，在这一领域也出版了许多专著。作为经合组织和欧盟委员会顾问，Ben Terra教授曾参与不同国家税务部门重组、法律起草及税务人员培训的工作。

讲座内容简介

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In this report, we look at the indirect tax supply chain issues that multinationals face when operating in today’s world. We examine how they tackle these issues in practice, drawing on some of the lessons they have learned and the “leading practices” they have developed.

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T Magazine Issue 07, The global executive: In our photo story “Living costs,” the average monthly rent for a furnished two-bedroom apartment in Panama City is stated to be US$291.67 on page 26 (page 20 in the Financial Times supplement). In fact, it is US$591.67.
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