



TACKLING TRANSACTIONAL TAXES

VAT/GST taxes belong on the risk management radar screen

By William Morrison

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From the outset, the Sarbanes-Oxley Act focused considerable attention on risk management of corporate income taxes, with more than 50 percent of material weaknesses attributed to tax issues. The Financial Accounting Standards Board (FASB) issued Interpretation No. 48, which clarifies the accounting for income tax uncertainties in accordance with FASB Statement No. 109, further sharpening this focus. This attention on corporate income taxes puts tax practitioners and business owners in danger of overlooking transactional taxes, which can pose even greater risks to corporations if misreported.

Transactional taxes are accounted for under FASB Statement No. 5, the standards of financial accounting and reporting for loss contingencies. The standards and regulations, however, are complicated. For instance, transactional tax rules have to be applied in real-life transactions, where small differences in the detailed nature of transactions, such as the location of the customer and type of product or service, can trigger different rates, exemptions or tax payment options.

Types of transactional taxes

Value Added Taxes (VATs) and Goods and Service Taxes (GSTs) are transactional taxes that are similar in nature and apply in most of the major business jurisdictions outside of the United States. All states of the European Union operate a broadly standardized VAT system. Russia, India, China, South Africa, Mexico, Argentina, Chile and Brazil also operate VATs. Canada, Australia, New Zealand and Singapore operate GSTs. Other types of transactional taxes include United States state and local transactional taxes, and customs and excise duties.

When dealing with transactional taxes, multistate and multinational businesses need

to track the bewildering variety of regimes in the jurisdictions in which they trade, and the interaction of those regimes when trading from one jurisdiction to another.

Deconstructing VAT and GST

VATs and GSTs are taxes charged on the supply of goods and services. The aim is for the burden of the taxes ultimately to be borne by the consumer, rather than by businesses. However, the taxes are collected by tax-registered businesses that are required to add a VAT/GST percentage to the prices they charge their customers and periodically remit the VAT/GST collected to the tax authority as an output tax. For tax authorities, this is a very efficient tax to collect. It has been calculated that it costs less than one-tenth of a penny to collect one dollar in VAT/GST.

In that respect, VATs/GSTs are similar to most U.S. state sales taxes. A crucial difference lies in how the taxes allow businesses to escape a tax cost on goods or services that they trade rather than consume. In most U.S. sales tax regimes, this is achieved by exempting business-to-business sales. In VAT/GST systems, business-to-business transactions remain taxable.

A VAT-registered supplier will charge VAT to all of its customers. Business customers can then claim a refund from the authorities of the VAT paid out on their costs as an input tax. The refund will normally be granted as a credit against the VAT the business will owe to the authorities from its own ongoing taxable sales. In many jurisdictions, however, direct refunds are possible in certain circumstances. An example is a business start-up where input tax is incurred before there is any offsetting output tax generated against it, or where a foreign company incurs input VAT in a jurisdiction without ever making taxable sales there.

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Transactional taxes can apply to all sales and purchases a business makes, not just to its much smaller profit figure. And they can apply at a surprisingly high rate – up to 25 percent in some countries. The volume of transactional tax throughput in a business can be vastly greater than that for profit-based taxes. The costs of a serious error can be much higher and can easily turn a profit into a loss.

Moving forward to mitigate risk

Some of the most important risk-mitigating tools are knowledge, controls and technology solutions. Building expertise in VAT and GST, and making the knowledge accessible to the accounting and operational staff, is a good way to set a solid foundation for understanding transactional taxes. With expert knowledge, businesses can set procedures for creating and documenting VAT and GST controls when new territories are entered, new contracts are concluded and invoices are raised or received.

Technology solutions are available to organize transactional tax information, mitigating risk and ensuring transactions are accurate. For instance, the VAT/GST functionality is available in most enterprise resource planning (ERP) systems. Tax engines that can be integrated into standard ERP systems can offer even more sophisticated VAT/GST controls.

VAT/GST taxes belong on the risk management radar screen for multinational corporations. There is too much money at stake to ignore them. Although their complexity can seem daunting, risk can be managed by the application of sensible controls.

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COMMON VAT/GST RISKS

Very few multinational companies have simple VAT/GST situations. With complexity often comes risk, including:

Output tax

- Application of incorrect rates or exemptions to transactions
- Failure to register as a VAT/GST taxpayer due to doing business in a foreign jurisdiction and failure to account for potential liabilities
- Failure to properly apply complex rules on interjurisdictional transactions
- Failure to produce invoices with the full administrative requirements for tax documents

Input tax

- Over- or under-recovery of input tax credits due to failure to understand local recovery rules
- Failure to use recovery schemes for non-established companies in foreign jurisdictions (it is estimated that billions of dollars have gone unclaimed in this way)
- Failure to obtain correctly formatted invoices from suppliers for tax recovery
- Failure to restrict input tax recovery properly where the business has some exempt sales