

TAX

2005

The Growing Burden?

The impact of VAT/GST around the World

 **ERNST & YOUNG**

Quality In Everything We Do



“ As VAT rates have risen,
VAT compliance has
become a major issue.
Governments are less
open to adopting
measures to simplify the
application or collection
of VAT. ”

Foreword

Indirect tax is often the forgotten tax on business. More often than not finance directors view indirect tax as a process-oriented throughput cost rather than as a direct charge to the bottom line.

My colleagues and I are often surprised by just how tolerant – and occasionally uninformed – some finance directors are of failures to track, fully report and legitimately reclaim their indirect taxes. If your margin of error on tracking and recovering is just five per cent of your indirect taxes, then on a turnover of several billion it soon adds up to a significant sum being lost every year. Add on top the administration and systems costs and it soon becomes clear that these taxes need to be viewed in the global context and not just as pockets of individual local tax that can be ignored by headquarters.

These lapses in tracking and recovery have more than a financial implication. For most multinationals, the value added tax (VAT) account would be considered to be a “significant account” for Sarbanes-Oxley 404 internal controls reporting purposes. Given the fact that

most value added taxes are levied outside of the United States, it is our view that the market has yet to fully appreciate the impact these taxes will have on internal control reporting, and will only do so when foreign public company registrants undergo attestation. Equally, any other internal controls reporting regulations will need to be carefully scrutinized to ensure that there is consistent interpretation with regard to the impact on the VAT account.

In creating this report we have analyzed indirect tax rates and trends in more than sixty countries around the world based on data we collect for our market-leading Worldwide VAT and GST Guide. While we recognize the rights of governments to collect consumption taxes we use this report to call on them to make a number of practical changes and reforms of the system that would reduce the burden of administration and compliance, especially in relation to cross-border trade.

Peter Jenkins
Global Director of Indirect Tax



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Overview and call to action



Value added tax (VAT) (also known as Goods and Services Tax (GST) in some countries) is designed to be a tax on consumption. In our view, it is also a tax on business. While taxable persons are supposed to be the tax collectors in the VAT system, in reality they are often net taxpayers. Taxable businesses bear VAT as a cost in a variety of ways, many of them hidden. Exempt businesses bear VAT on their costs through input tax credit restriction.

Ernst & Young's *Worldwide VAT and GST Guide 2005* is based on research conducted in more than 60 countries throughout the Ernst & Young global tax network. This report highlights some of the differences in the countries covered by that guide and some of the consumption tax issues and trends facing businesses and governments around the world. The comparison shows broad differences in VAT rates around the world and in the compliance costs and VAT burden borne by individual consumers and by taxable persons.

VAT and similar consumption taxes are increasing in importance as a source of government revenues worldwide. The number of countries that levy VAT has continued to rise and now stands at about 140. India has recently introduced the tax and Malaysia plans to do so.

The introduction of a Federal VAT is once again under consideration in the United States, as part of a possible tax reform.¹ Many governments are shifting the emphasis of their taxation policy from taxing earnings and gains to taxing consumption. In some countries, such as Hungary, VAT is the major source of government revenue.

Worldwide, consumption taxes are playing an increasingly important role in the tax policy of developed countries. As the Organization for Economic Co-operation and Development (OECD) noted in a recent report concerning the application of VAT to cross border services:²

"The rapid growth in international trade has coincided with the global spread of value added taxes, with some 140 countries now using such taxes.

The revenue from such consumption taxes has increased significantly as a proportion of total government revenues in many OECD countries and beyond in recent years due to a reorientation of tax systems towards taxation of consumption and away from taxation of labor and investment."

In 2002, taxes on consumption represented an average of 6.8% of Gross Domestic Product (GDP) in OECD countries.³

¹ Congressional Research Service Issue Brief "Value-Added Tax as a New Revenue Source," updated 14 June 2005.

² "The Application of Consumption Taxes to the International Trade in Intangibles and Services" copyright Organization for Economic Co-operation and Development 2005

³ "Statistiques des recettes publiques des pays membres de l'OCDE 1965-2003" copyright Organization for Economic Co-operation and Development 2004

As a result, there is a strong correlation between the VAT rate and the overall taxpayer burden; the countries that impose the highest VAT rates typically also have the highest overall taxation ratios according to recent research undertaken by Ernst & Young.⁴

Governments must balance the need to protect an important source of revenue with the economic impact of VAT. Ideally, taxes on consumption should not affect competitiveness. In practice, differences between VAT systems do create or increase competitive distortions, both between individual businesses and between countries. VAT rates may influence consumer behavior, particularly in countries and trading blocs that allow free movement of goods between taxing jurisdictions, such as India and the European Union. Differences in how taxpayers are treated may discourage inward investment or may prevent businesses from competing internationally.

Consumption taxes not only add to the tax burden of individual taxpayers, they also have a direct impact on the tax burden borne by corporations. Traditionally, VAT has been assumed to be tax neutral for most businesses, unlike taxes on capital and income. This assumption is incorrect. VAT contributes directly to effective tax rates for corporations in VAT-exempt sectors,

such as finance, healthcare and education.

At the same time, few enterprises currently devote significant resources to managing VAT. Businesses are largely unaware of the true cost of VAT, as few measure it. In our view, VAT management should be treated as a priority, especially by multinational corporations. This approach is necessary to comply with corporate governance standards in many countries. It may also benefit companies by allowing them to minimize VAT costs and the enterprise risks associated with VAT compliance. Unlike other taxes, VAT is levied on nearly all business transactions, so that large quantities of VAT flow through the accounts of most businesses every day. A small error rate in processing the tax — even of just 5% — may lead to significant liabilities on a turnover of several million.

We fully acknowledge and support the rights of governments to collect consumption taxes, to protect their tax bases and to take appropriate measures to ensure the accuracy of VAT filings and receipts. However, we believe that taxable businesses should not bear an excessive or unfair responsibility for the collection of the tax, in terms of business administration, in the assumption of risk or in terms of hidden costs.

We welcome the attention that the OECD has drawn to the issue of VAT compliance burdens, especially in the area of e-commerce.⁵ We also welcome the measures taken in recent years by the European Union (EU) to simplify VAT invoicing and to adopt a “one-stop shop” approach for some nonresidents. We urge the Community to continue to simplify VAT administration for all businesses that operate in the EU, especially in relation to cross-border services and to the intra-Community trade in goods.

We call on governments worldwide to reduce the burden of VAT for taxable businesses and propose a number of measures, including:

- **Bi-lateral or multi-lateral VAT treaties to resolve jurisdictional disputes, e.g. regarding the place of taxation (primarily for services) and to eliminate economic double taxation arising from VAT.** The OECD could provide guidance in this area, perhaps in the form of a model treaty or sample treaty clauses for inclusion in existing tax treaties.
- **Internationally agreed standards for VAT invoicing** (including electronic invoicing).

⁴ “The Only Constant? Changing Tax Rates Across the OECD” Ernst & Young 2005

⁵ “Facilitating Collection of Consumption Taxes on Business-to-Consumer Cross-Border E-Commerce Transactions” and “The Application of Consumption Taxes to the International Trade in Intangibles and Services” copyright Organization for Economic Co-operation and Development 2005

- **Measures aimed at easing the compliance burden for nonresidents** (including electronic filing, the adoption of approved VAT collection software for business-to-consumer (B2C) transactions, and the approval of tax agents).
- **Measures aimed at easing VAT compliance for small to medium-sized businesses (SMEs)** (including monthly invoicing, electronic filing, extended VAT return periods, cash accounting options and realistic filing deadlines).
- **VAT refunds to be granted to nonresident businesses by all countries that operate a VAT or multi-stage tax system.**
- **The addition of economic interest to late-paid VAT refunds (for example, after six months) for resident and nonresident claimants.**
- **VAT facilitation measures** that balance the needs of revenue authorities and of taxpayers, including **VAT grouping, accelerated refunds for exporters and relief for VAT on bad debts.**
- **The adoption of “proportionate” measures to combat tax evasion or avoidance**, that is, the adoption of measures that do not impose excessive compliance burdens on large numbers of businesses to secure a small amount of tax.
- **A reduction in the number and scope of VAT exemptions (without credit) that apply to business-to-business (B2B) transactions, such as bank finance charges and real estate costs.** This could be achieved by an option to tax transactions involving taxable businesses (such as the options that currently apply in France, Germany and the United Kingdom). Governments could also re-examine proposals to tax financial services and how VAT on these transactions may be calculated.
- **Automatic permission for partly exempt taxable persons to use special methods to calculate VAT recovery.** Many countries currently require all partly exempt businesses to use a set method to calculate VAT recovery. Often, the required method is a simple pro rata allocation based on values of taxable and exempt supplies made. High-value transactions can easily distort this type of calculation. Tax authorities should allow partly exempt businesses greater scope to apply calculation methods that accurately reflect their use of VAT and to disregard incidental exempt supplies on a consistent basis.
- **Recognition that exports of goods and services should be fully relieved of “sticking” VAT in the supply chain, including financial services and insurance.** “Key and benefit” provisions should apply to exported services only when strictly necessary.

The Burden of VAT for Final Consumers

In considering the impact of the VAT burden, the category of “final consumers” should not be restricted to private individuals. Most VAT systems contain a series of exemptions and exclusions that prevent the full deduction of VAT by business entities. In effect, the category of “final consumer” applies to a wide variety of persons, including:

- Private individuals;
- Entities that do not undertake economic activities, such as governmental bodies, charities and international organizations;
- Business entities whose economic activities are wholly or partly excluded from the right to VAT recovery, for example, partly exempt taxable persons;
- Business entities that are excluded from the VAT system, for example,

small enterprises; and

- Taxable persons that incur irrecoverable VAT costs.

Worldwide VAT Rate Comparison

A wide range of VAT rates apply worldwide. Differences apply between individual countries (see Figure 1) as well as among regions (see Figure 2). The overall average VAT rate in the 62 countries surveyed is 16.4%. The highest standard VAT rate in the countries surveyed is 25%; this rate applies in Denmark, Hungary, Norway and Sweden. The lowest standard VAT rate in the countries surveyed is 5%; this rate applies in Panama, Singapore and Japan.

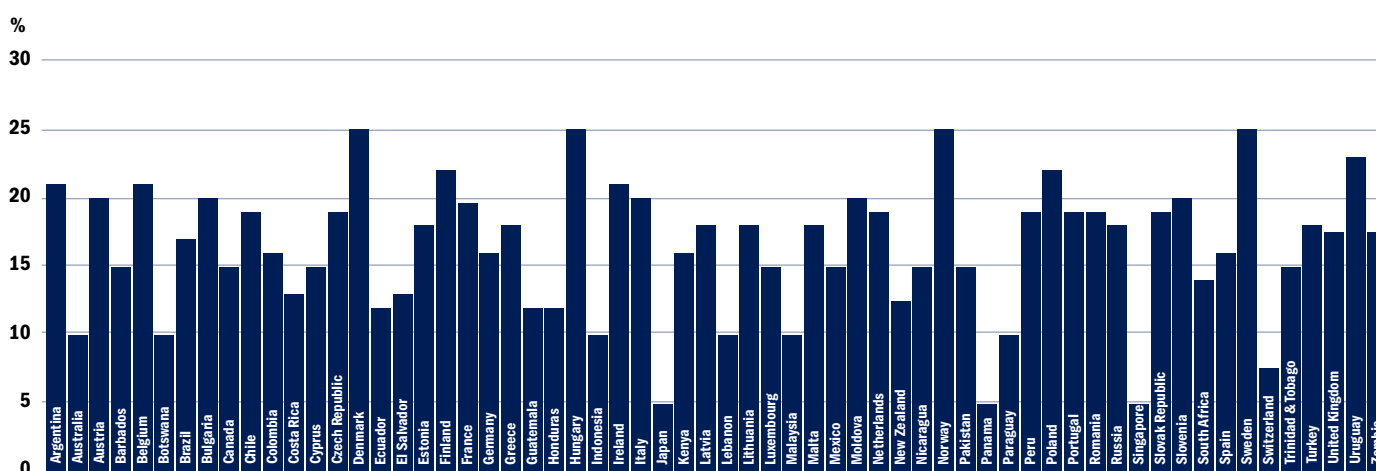
Regionally, the highest standard VAT rates are found in Europe (18.7%) and

the lowest VAT rates in the Asia Pacific region (10.5%). The average regional rates are also lower than the worldwide average rate in Africa (at 14.5% in the countries surveyed) and in the Americas (at 14.8% in the countries surveyed). These trends in VAT rates closely mirror the conclusions drawn in Ernst & Young’s recently published report on worldwide tax rates, which found European taxpayers bear the heaviest tax burden overall.⁶

Additional VAT Rates

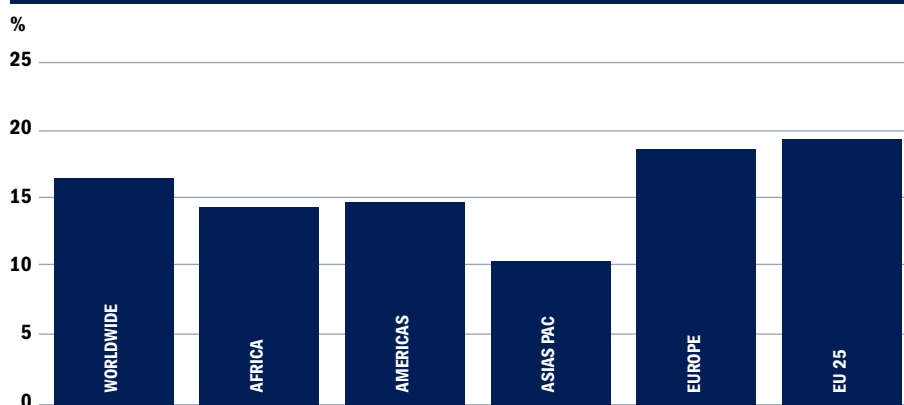
Most countries apply more than one rate of VAT and some countries apply several VAT rates. Therefore, the actual consumption burden felt in any country depends on the mix of VAT rates that apply and the percentage of average expenditure that is taxed at different

Figure 1. Standard Rates - Worldwide



⁶ “The Only Constant? Changing Tax Rates Across the OECD” Ernst & Young 2005

Figure 2. Regional Average VAT Rates



rates. The existence and mix of rates, therefore, greatly influence the actual VAT burden suffered by final consumers in each country.

Increased Rates

A few of the countries surveyed, including Colombia and Panama, apply higher rates to “luxury” or non-essential items, including mobile telephones, vehicles, alcoholic beverages and cigarettes. In Brazil, several VAT taxes apply, each with a range of VAT rates. The highest rate of the Federal VAT,⁷ which applies to “finished goods,” is 330%.

Reduced Rates

Most countries in the Europe, Africa and Americas regions apply reduced rates or zero rates. The specific items and activities that benefit from reduced VAT rates vary greatly between countries. Reduced rates generally apply to goods and services that are considered to be

“essential” or “basic” items. Some countries also use reduced rates to help sectors of the economy, such as tourism or personal service industries. The items chosen often depend on countries’ different cultures and on their overall taxation policies and economic priorities. Common items to benefit from a reduced (or zero) rate include medicines, basic foodstuffs, books and magazines, public housing and heating fuel.

The average reduced VAT rate in all of the countries surveyed is 5.5%. In Europe, the average reduced rate is 6.6% and in the Americas the average reduced rate is 3.7%. These regional averages closely mirror the trends for standard VAT rates, discussed earlier.

Exemptions

All of the countries surveyed in the *Worldwide VAT & GST Guide* apply a range of exemptions from VAT.

Exemptions may be divided into two main types: exemptions without credit for tax paid by the supplier and exemptions with credit (sometimes referred to as “zero rating”).

Exemption with credit may apply to goods and services that benefit final consumers, and is commonly restricted to basic necessities such as food or textbooks. Exports of goods and services generally also benefit from exemption with credit; exemption applies to achieve tax neutrality for cross-border trade.

Exemptions without credit may be divided into two common categories. In many countries, exemptions apply to activities that are considered to be for the “social good,” including education, cultural services and health care. Exemption also frequently applies to business activities that are difficult to tax accurately under a VAT system, such as gambling, financial transactions and transactions in real estate. The impact on business costs of these exemptions without credit is discussed later in this report, in the chapter *The Burden of VAT Exemption*.

European Union VAT Rates

The comparison of worldwide VAT rates indicates that the consumption tax burden borne by final consumers is generally heavier in Europe than elsewhere. This trend is even more

⁷ Imposto Sobre Produtos Industrializados (IPI).

marked if the regional comparison is restricted to the EU⁸ (see Figure 3). The average VAT rate in the 25 EU member states is 19.4%, a full three percentage points higher than the worldwide average (16.4%) and nearly nine percentage points higher than the average rate in Asia Pacific (10.5%). Only four EU countries apply a standard VAT rate that is lower than the worldwide average (Cyprus, Germany, Luxembourg and Spain). These regional differences have even increased in 2005, as Greece and Portugal have both recently raised their standard rates. However, those increases may be offset in 2006 if Hungary fulfills its plans to reduce its rate to 20% from 25%. The high VAT rates that apply in the EU, especially in Scandinavia, clearly contribute to Ernst & Young's recent

findings that taxpayers in the region bear the heaviest global tax burden.⁹

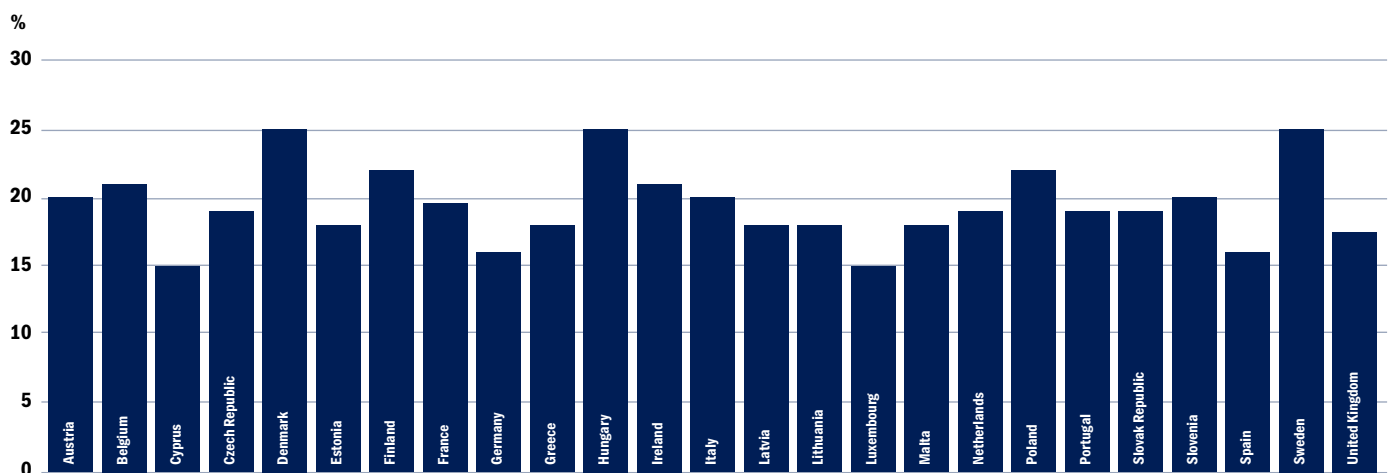
The EU's higher VAT rates are partly influenced by taxation policy. Under EU law, member states must apply a single standard VAT rate of at least 15%.¹⁰ This policy is aimed at protecting the institution's own revenues, which are made up from contributions from each member state's total VAT take. This rule is also designed to prevent distortions of competition between states within the Community's internal market by promoting "rate approximation."

However, EU policy has not been successful in promoting much rate harmonization within the single market. Wide differences still apply between

individual member states. Only two EU countries apply the Community minimum standard rate – Cyprus and Luxembourg. The majority of member states apply rates in the range of 17% to 20% and Denmark, Hungary and Sweden apply a rate that is ten percentage points higher than the minimum.

EU VAT law attempts to provide consistency on reduced rates and on goods and services that may benefit from reductions. However, in practice, uniformity is hard to achieve. A wide variety of reduced rates apply throughout the Community. In Finland, the reduced rate of 17% is higher than the standard rates in Cyprus, Germany, Luxembourg and Spain. At the same

Figure 3. EU Standard Rates



⁸ The 25 member states of the European Union are: Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden and the United Kingdom.

⁹ "The Only Constant? Changing Tax Rates Across the OECD" Ernst & Young 2005.

¹⁰ Article 12 (3) (a) EU Sixth VAT Directive.

time, four member states (Denmark, Ireland, Slovak Republic and United Kingdom) apply a zero rate to domestic supplies of some goods and services.

Given the burden of VAT on EU consumers, pressure continues within the European Union to maintain and expand the goods and services that may benefit from reduced rates. The issue is contentious, as it touches on individual states' social and fiscal policies. The 10 new member states that joined the European Union in 2004 have all negotiated temporary derogations that allow them to apply reduced rates on additional goods and services. At the same time, other member states are seeking to increase the approved list.

The Burden of VAT Exemption

The impact of VAT on business entities partly depends on the nature of their activities. Businesses that supply exempt goods and services suffer VAT as a tax cost because they do not recover input tax on expenditure or they do not recover it in full. As noted earlier, they are effectively treated as final consumers. Irrecoverable VAT adds to underlying business costs and has a direct impact on profit margins for businesses in the exempt sectors, such as banks, insurance companies, educational institutions and healthcare providers.

For these businesses, VAT rate differences may have a significant impact on their overall effective tax rate. In some cases, VAT considerations may even influence key operational decisions including place of establishment, organization or how transactions are undertaken.

Partial Exemption Calculations

Partly exempt businesses may generally recover input tax related to their taxable activities and may not recover input tax related to their exempt activities. This approach applies in all of the countries surveyed. The main difference between countries is in the methods used by partly exempt businesses to calculate VAT recovery (see Figure 4).

The detailed calculations required by partly exempt businesses add to the VAT compliance burden for these

taxpayers and increase their risk of substantial VAT accounting errors. Japan and Lebanon allow some taxpayers to use simplified partial exemption methods to reduce the administrative burden.

Most countries surveyed, including all of the countries in the EU, require partly exempt taxpayers to directly allocate input tax VAT to taxable and exempt supplies made. Where direct attribution does not apply, the most common calculation method is a basic pro rata allocation based on the value of taxable supplies made. The basic pro rata allocation is also commonly used for “mixed” input tax that cannot be directly allocated to one category of supplies. Mixed input tax may include such general business overheads as energy and telecommunications charges.

Some countries, such as Australia, Botswana, Ireland and the United Kingdom, allow or require taxable persons to use other allocation methods that may more accurately reflect the actual use of the input tax. These more detailed calculations may increase the compliance complexity. However, the availability of special methods may also benefit partly exempt businesses – by allowing them to choose the optimal recovery method to maximize VAT recovery related to their taxable activities.

Figure 4. Methods Used By Partly Exempt Businesses

| | DIRECT ALLOCATION | PRO RATA CALCULATION | SPECIAL METHODS |
|-------------------|-------------------|----------------------|--|
| Argentina | N/A | N/A | N/A |
| Australia | YES | YES | YES |
| Austria | YES | YES | NO |
| Barbados | YES | YES | NO |
| Belgium | YES | YES | YES |
| Botswana | YES | YES | YES |
| Brazil | N/A | N/A | N/A |
| Bulgaria | NO | YES | NO |
| Canada | YES | YES | YES |
| Chile | NO | YES | NO |
| Colombia | N/A | N/A | N/A |
| Costa Rica | N/A | N/A | N/A |
| Cyprus | YES | YES | YES |
| Czech Republic | YES | YES | NO |
| Denmark | YES | YES | NO |
| Ecuador | NO | YES | NO |
| El Salvador | NO | NO | NO |
| Estonia | YES | YES | NO |
| Finland | YES | YES | YES |
| France | YES | YES | YES |
| Germany | YES | YES | YES |
| Greece | YES | YES | NO |
| Guatemala | YES | NO | NO |
| Honduras | YES | NO | NO |
| Hungary | YES | YES | NO |
| Indonesia | YES | NO | NO |
| Ireland | YES | YES | YES |
| Italy | YES | YES | NO |
| Japan | YES | YES | YES - simplified regime for some taxpayers |
| Kenya | YES | YES | YES |
| Latvia | YES | YES | NO |
| Lebanon | YES | YES | YES - fixed percentages for some taxpayers |
| Lithuania | YES | YES | NO |
| Luxembourg | YES | YES | YES |
| Malaysia | N/A | N/A | N/A |
| Malta | NO | YES | NO |
| Mexico | NO | YES | NO |
| Moldova | YES | YES | NO |
| Netherlands | YES | YES | NO |
| New Zealand | YES | YES | YES |
| Nicaragua | YES | NO | NO |
| Norway | YES | YES | NO |
| Pakistan | N/A | N/A | N/A |
| Panama | N/A | N/A | N/A |
| Paraguay | N/A | N/A | N/A |
| Peru | N/A | N/A | N/A |
| Poland | YES | YES | NO |
| Portugal | YES | YES | YES |
| Romania | NO | YES | NO |
| Russia | YES | YES | NO |
| Singapore | YES | YES | YES |
| Slovak Republic | NO | YES | NO |
| Slovenia | YES | YES | NO |
| South Africa | YES | YES | YES |
| Spain | YES | YES | NO |
| Sweden | YES | YES | YES |
| Switzerland | YES | YES | YES |
| Trinidad & Tobago | YES | YES | NO |
| Turkey | YES | N/A | NO |
| United Kingdom | YES | YES | YES |
| Uruguay | YES | N/A | N/A |
| Zambia | NO | YES | NO |

Capital Goods

Capital goods are items that are used in a taxable business over a period of time. Some countries in Latin America, including Colombia and Costa Rica, do not generally allow input tax recovery on assets except in certain circumstances. Elsewhere, VAT is generally recoverable on purchases of capital goods in the VAT year when they are acquired.

Canada, New Zealand and all the EU member states require an adjustment to the amount of VAT recovered with respect to a capital asset if the taxpayer's partial exemption status changes in a specific period after its acquisition (see Figure 5). In the EU, the adjustment generally applies to immovable property for a period of either 10 or 20 years and to "other assets" for a period of 5 years. Wide variations apply, however, among EU countries as to which "other assets" are covered. For example, in Austria the five-year adjustment applies to most fixed assets, whereas, in the United Kingdom, it applies exclusively to high-value computer hardware.

Figure 5. Capital Goods

| | CAPITAL GOODS ADJUSTMENT PERIOD | CAPITAL GOODS NOTES |
|----------------|---|--|
| Austria | Immovable property - 10 years Other assets - 5 years | Fixed assets if the input VAT exceeds €220 |
| Belgium | Immovable property - 15 years Other assets - 5 years | |
| Canada | | Special recovery rules apply to capital assets |
| Colombia | | VAT is not deductible for most fixed assets, special rules apply in certain cases e.g. producers of exempt or excluded goods |
| Costa Rica | | VAT is not generally deductible for fixed assets |
| Cyprus | Immovable property - 10 years Other assets - 5 years | Assets covered include property rights, trademarks patents and goodwill valued at £10,000 or less |
| Czech Republic | Immovable property - 5 years Other assets - 5 years | The adjustment applies to tangible assets greater than CZK 40,000 and intangible assets greater than CZK 60,000 |
| Denmark | Immovable property - 10 years Other assets - 5 years | Other assets include machinery, equipment and furniture, and renovation of land and buildings valued at DKK 75,000 or more |
| Estonia | Immovable property - 10 years Other assets - 5 years | A one-time adjustment applies to immovable property disposed of within 10 years, if the disposal is exempt |
| Finland | Immovable property - 5 years | The adjustment is restricted to immovable property, and construction and renovation costs for immovable property |
| France | Immovable property acquired prior to 1 January 1996 - 10 years Immovable property acquired after 1 January 1996 - 20 years Other assets - 5 years | |
| Germany | Immovable property - 10 years Other assets - 5 years | The adjustment applies to current assets and services |
| Greece | Immovable property - 5 years Other assets - 5 years | The adjustment applies to movable capital assets |
| Hungary | Immovable property - 10 years Other assets - 5 years | The adjustment applies to tangible capital assets |
| Italy | Immovable property - 10 years Other assets - 5 years | Other assets as defined in the Italian Civil Code |
| Lithuania | Immovable property - 10 years Other assets - 5 years | The adjustment applies to assets depreciated for taxes on profit or income |
| Luxembourg | Immovable property - 10 years Other assets - 5 years | |
| Malta | Immovable property - 20 years Other assets - 5 years | |
| Netherlands | Immovable property - 10 years Other assets - 5 years | |
| New Zealand | Straight-line depreciation applied to the cost or current market value | |
| Peru | Input tax is deductible on capital assets in the month of acquisition | |
| Poland | Immovable property - 10 years Other assets - 5 years | The adjustment applies to assets valued at PLN 3,500 or more |
| Portugal | Immovable property - 20 years Other assets - 5 years | The adjustment does not apply to assets valued at less than €250 or to goods with a useful life of less than 5 years |
| Slovenia | Immovable property - 20 years Other assets - 5 years | |
| Spain | Immovable property - 10 years Other assets - 5 years | The adjustment does not apply to assets valued at less than €3,500 |
| Sweden | Immovable property acquired before 1 January 2001 - 6 years Immovable property acquired after 1 January 2001 - 10 years Other assets - 5 years | The adjustment applies to immovable property acquired prior to 1 January 2001 that cost more than SEK 200,000. The adjustment applies to immovable property acquired after 1 January 2001 that cost more than SEK 400,000. The adjustment for other assets applies to machinery and equipment acquired that cost more than SEK 200,000 |
| United Kingdom | Immovable property - 10 years Computer hardware - 5 years | The adjustment applies to immovable property valued at £250,000 or more and to computer hardware valued at £50,000 or more |

VAT Grouping

VAT grouping allows closely related business entities (usually corporate bodies) to be treated as a single entity for VAT purposes. VAT grouping is a useful facilitation measure that may benefit both taxpayers and tax administrations. However, grouping is available in only 20 of the 62 countries surveyed (see Figure 6). Among the countries that permit VAT groups, differences exist as to the types of entities that may group and as to the effects of grouping.

Most countries restrict grouping to closely related corporate bodies and exclude nonresident entities. In Hungary, grouping is further restricted to financial institutions, investment companies and insurance companies, whereas in Germany group treatment applies automatically to all qualifying entities.

In Italy, VAT grouping is effectively an administrative measure that improves group cash flow, by allowing companies to consolidate VAT payments and refunds due to the group. In most of the other countries that allow grouping, its effects are more significant – no VAT is charged on transactions between group members. This provision is particularly useful for exempt and partly exempt entities, as it avoids the addition of irrecoverable VAT to inter-company charges.

In recent years, some countries, including the United Kingdom, have sought to limit the effects of grouping for some partly exempt entities in cases where planning has been perceived to be abusive. However, this effect of grouping could be argued to be one of its main justifications within the VAT system. It prevents a distortion of competition between businesses that are vertically and horizontally integrated.

Figure 6. Countries That Allow VAT Grouping

| |
|----------------|
| Australia |
| Austria |
| Canada |
| Cyprus |
| Denmark |
| Estonia |
| Finland |
| Germany |
| Honduras |
| Hungary |
| Ireland |
| Italy |
| Netherlands |
| New Zealand |
| Norway |
| Singapore |
| Sweden |
| Switzerland |
| United Kingdom |
| Zambia |

The Compliance Burden of VAT

For fully taxable businesses, the most significant impact of VAT is the cost of compliance. As the unpaid tax collectors of the VAT system, taxable persons bear considerable responsibility for the integrity of the whole system. VAT fraud and evasion may seriously undermine the revenue base of countries, especially those that rely on VAT for a large proportion of their government revenues. As a result, VAT accounting requirements are stringent, and penalties for noncompliance are severe. Taxable

persons may incur considerable accounting costs and burdens to ensure full compliance with their obligations. In particular, the need to manage and administer VAT compliance contributes to the overall level of enterprise risk.

Other hidden VAT costs for fully taxable businesses include increased service charges paid to exempt businesses, increased IT investment to produce accurate VAT returns within tight deadlines; increased accounting and management time needed to deal with returns and VAT-related issues; irrecoverable foreign VAT; penalties for VAT errors; and increased financing costs related to VAT payments, bad debts and overdue refunds.

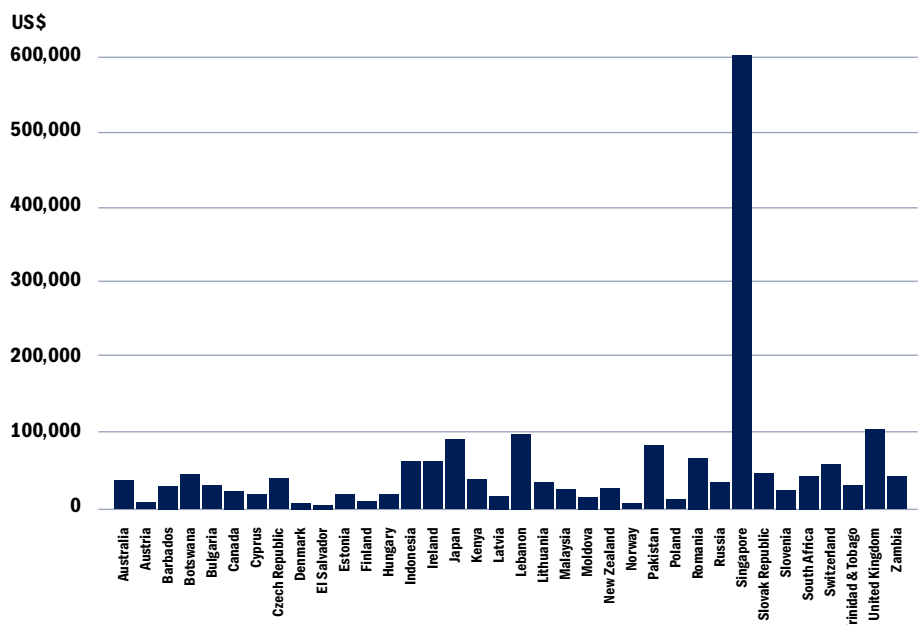
VAT Registration Thresholds

All of the countries surveyed maintain registers of VAT taxpayers. Some countries require businesses to register for VAT purposes as soon as they commence activity (see Figure 7). Other countries allow businesses to avoid VAT registration until their turnover has reached certain levels. The annual turnover thresholds for VAT registration vary greatly between countries (see Figure 8). In US dollar amounts, they currently range from \$5,716, in El Salvador to \$600,000 in Singapore. In the EU, the highest registration threshold (roughly US\$105,000) applies in the United Kingdom. The average VAT registration threshold in the European Union is approximately US\$17,300.

Figure 7. Countries With No Turnover Threshold For VAT Registration

| |
|-------------|
| Belgium |
| Brazil |
| Chile |
| Colombia |
| Costa Rica |
| Ecuador |
| France |
| Germany |
| Greece |
| Guatemala |
| Honduras |
| Italy |
| Luxembourg |
| Malta |
| Mexico |
| Netherlands |
| Nicaragua |
| Panama |
| Paraguay |
| Peru |
| Portugal |
| Spain |
| Sweden |
| Turkey |
| Uruguay |

Figure 8. Annual Turnover Thresholds For VAT Registration



VAT Returns

VAT returns represent a major compliance task for taxable persons in all the countries surveyed. Wide differences apply between countries with respect to the frequency of returns, the deadlines for submission and the severity of penalties for errors and omissions related to VAT returns.

The majority of countries surveyed (52 countries) require some or all VAT taxpayers to submit returns on a monthly basis. Ten countries surveyed use bi-monthly returns, including Ireland, Norway and New Zealand; 27 countries surveyed use quarterly return periods, including Cyprus, Malta and the United Kingdom. Most countries also provide for less frequent reporting periods (quarterly, bi-annual or annual) for small businesses.

Some countries require taxable persons

to submit an annual return or recapitulative statement in addition to periodic returns. Taxable persons in the European Union also complete reports that provide information on trade with business customers located in other EU countries.

The number, complexity and frequency of returns place a heavy burden on taxable persons of all sizes throughout the world and contribute to the risk of error. SMEs may find that the costs of full compliance are disproportionate to sales volume. As a result, many countries permit small businesses to submit less frequent returns than other taxable persons.

Multinational companies may also face particular difficulties in meeting their obligations. A global corporate organization may be required to complete nearly 1,000 VAT reports annually. The great differences between

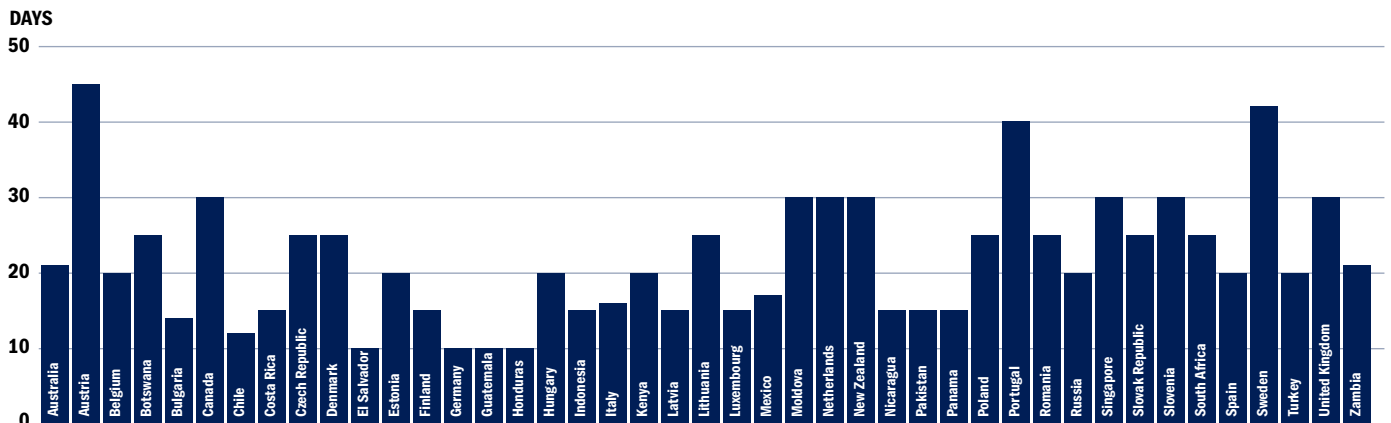
countries' return requirements, even within regions or closely linked trading blocs, may prevent efficiencies. Shared services centers that complete and submit returns for a number of countries risk committing errors for lack of detailed local knowledge. Enterprise-wide software systems that apply VAT conditions automatically may even increase compliance risks unless they are accurately configured.

VAT Payments

Due dates for VAT returns and payment vary greatly worldwide. The compliance burden for VAT returns may be increased by tight deadlines. Funding VAT payments and delayed refunds greatly contribute to individual businesses' borrowing requirements.

For monthly returns, the due date varies between 10 days and 42 days after the end of the return period (see Figure 9);

Figure 9. Monthly Return Due Dates



for quarterly returns the due date varies from 10 days to 60 days after the end of the return period (see Figure 10). VAT payments may have a significant effect on cash flow and on the borrowing requirements of individual businesses. In countries with short VAT payment deadlines, taxable persons may carry a heavier level of indebtedness to meet their VAT return obligations.

Irrecoverable Input VAT

Not all legitimate business costs and overhead expenses are allowable for input tax deduction. However, the specific items that are disallowed vary greatly between countries.

In a few countries, mainly in Latin America, input tax deduction is restricted to goods and services that are directly incorporated into taxable merchandise or services. Nondeductible input tax may have a significant impact

on the profitability of taxable businesses in these countries and may discourage capital investment or may harm their ability to compete internationally.

Elsewhere, irrecoverable inputs represent a small percentage of total business expenditure for most fully taxable businesses. In most of the countries surveyed, irrecoverable items are typically restricted to expenses that may have some non-business or private use, such as entertainment costs, hotel and restaurant bills, tobacco and alcohol and motoring expenses. However, in some industry sectors, amounts of disallowable expenditure may become significant. Organizers of conferences and trade fairs, for example, may incur large amounts of irrecoverable VAT on hotel and restaurant services, even though these costs are then passed on to other taxable businesses. Differences in VAT

recovery worldwide may influence where businesses in these sectors conduct their activities.

VAT Refunds

If the amount of VAT recoverable as input tax in a period exceeds the amount of VAT due on sales, a taxable person has a VAT credit. Some businesses, such as frequent exporters, may incur VAT credits on a regular basis. The treatment of refunding VAT credits varies greatly among countries (Figure 11). These differences may contribute significantly to the level of VAT burden felt by taxable persons in different countries and in their financing requirements.

Only about a third of the countries surveyed refund a VAT credit automatically. A minority of countries, all located in Latin America, do not permit a refund at all. The remaining

Figure 10. Quarterly Due Dates

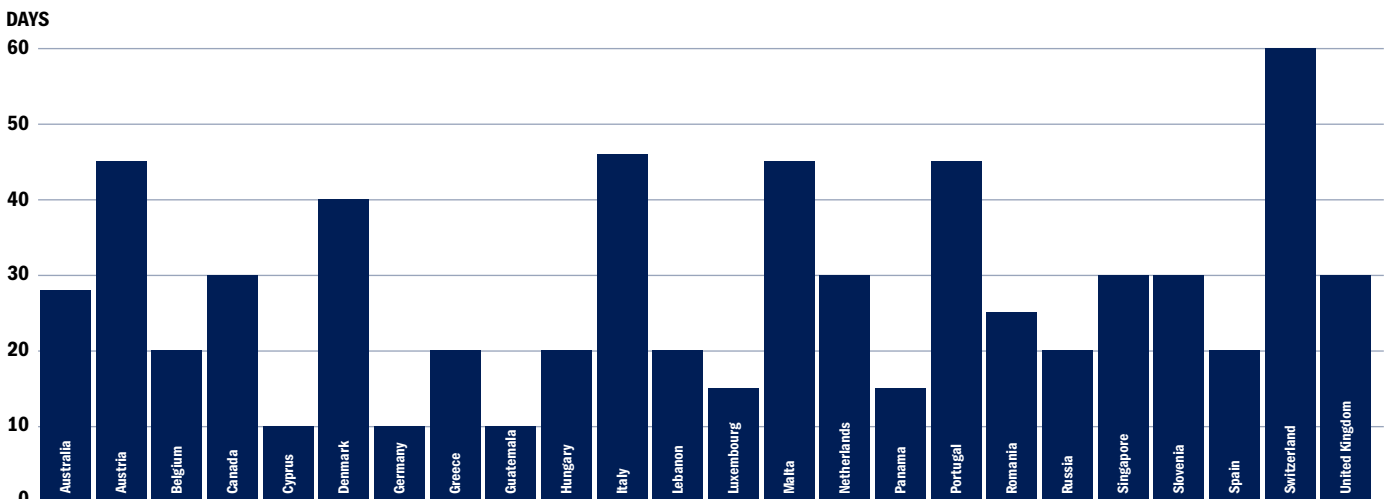


Figure 11. Refunding VAT Credits

| COUNTRY | OFFSET OTHER TAXES | CARRY FORWARD | AUTOMATIC REFUND | REFUND AFTER OFFSET OR IN SPECIAL CASES | COMMENTS | SPECIAL RELIEF OR ACCELERATED REFUNDS FOR FREQUENT EXPORTERS |
|---------------------|-----------------------------|---------------|------------------|---|---|--|
| Argentina | NO | YES | NO | NO | Interest at 0.5% a month is added if tax overpaid in error | |
| Australia | YES | NO | YES | N/A | Refunds must be paid into an Australian bank account | |
| Austria | NO | NO | YES | N/A | | |
| Barbados | NO | NO | YES | N/A | Interest applies after 6 months | |
| Belgium | NO | YES | NO | N/A | Some taxpayers may request monthly refunds | YES |
| Botswana | YES | NO | NO | YES | Some taxpayers may receive monthly refunds | YES |
| Brazil | YES | NO | NO | NO | In some cases, a right to a refund may be transferred to a third party for consideration | |
| Bulgaria | NO | YES | NO | YES | Refunds are restricted to certain taxpayers, others must carry excess credit forward for 3 months | YES |
| Canada | NO | NO | YES | N/A | | |
| Chile | NO | YES | NO | YES | Refunds may be requested if tax overpaid in error | |
| Colombia | NO | N/A | NO | YES | Refunds are limited to certain taxpayers | YES |
| Costa Rica | YES | YES | NO | NO | Offset against other taxes is restricted to taxpayers who foresee they will not use the excess credit against output tax in 3 months | |
| Cyprus | NO | YES | NO | YES | Refunds are restricted to certain taxpayers, others must carry the excess forward | YES |
| Czech Republic | YES | YES | YES | N/A | | |
| Denmark | NO | YES | YES | N/A | | |
| Ecuador | NO | YES | NO | NO | | |
| El Salvador | NO | YES | NO | YES | Refunds are restricted to taxpayers who foresee they will not use the excess credit against output tax | |
| Estonia | YES (against penalties) | NO | YES | N/A | | |
| Finland | NO | YES | NO | YES | Refunds are limited to certain taxpayers. Others must carry forward the excess to the end of the calendar year. Taxpayers in a constant refund position may request monthly refunds | YES |
| France | NO | YES | NO | YES | Refunds are limited to certain taxpayers. Others must carry forward the excess to the end of the calendar year (€150) or quarter (€760). Taxpayers who predominantly make exempt with credit supplies may request monthly refunds | YES |
| Germany | NO | NO | YES | N/A | A bank guarantee may be requested by the tax authorities | |
| Greece | NO | YES | NO | YES | Refunds are limited to certain taxpayers. Others must carry forward the excess | |
| Guatemala | NO | YES | NO | YES | Refunds are limited to certain taxpayers. Others must carry forward the excess | YES |
| Honduras | YES (and against penalties) | YES | NO | NO | The excess must be carried forward for 6 months before offset | |
| Hungary | NO | YES | NO | YES | Refunds are limited to certain taxpayers. Others must carry forward the excess. Interest is paid on late refunds | |
| Indonesia | NO | NO | YES | N/A | Interest paid on late paid refunds at 2% per month | |
| Ireland | NO | NO | YES | N/A | A taxable person that normally receives refunds may request monthly returns | YES |
| Italy | YES | YES | NO | YES | Quarterly and annual refunds are limited to certain taxpayers. Others must carry forward the excess | YES |
| Japan | N/A | N/A | N/A | N/A | | |
| Kenya | NO | YES | NO | YES | Refunds are limited to certain taxpayers or circumstances | YES |
| Latvia | NO | YES | NO | YES | Excess VAT must be carried forward to the end of the tax year | |
| Lebanon | NO | YES | NO | YES | Quarterly refunds are limited to exporters. Others must carry forward the excess to the end of the year. Interest is paid on late refunds at an annual rate of 9% | YES |
| Lithuania | YES | NO | NO | YES | The credit must be offset against other taxes before it is refunded | |
| Luxembourg | NO | YES | NO | YES | A refund may be claimed if the credit is in excess of €1,200 | |
| Malaysia | N/A | N/A | N/A | N/A | | |
| Malta | NO | YES | YES | N/A | Interest is paid on late refunds at 1% a month. | |
| Mexico | NO | YES | YES | N/A | | |
| Moldova | NO | YES | NO | YES | Refunds are limited to certain taxpayers. | YES |
| Netherlands | NO | NO | YES | N/A | | |
| New Zealand | NO | NO | YES | N/A | | YES |
| Nicaragua | YES | YES | NO | YES | Offset and refunds are limited to certain taxpayers. Others must carry forward the excess. | YES |
| Norway | NO | NO | YES | N/A | Interest is paid on late refunds at 0.5% a month | |
| Pakistan | NO | YES | NO | YES | Excess credit must be carried forward for 6 months | |
| Panama | YES | YES | NO | NO | | YES |
| Paraguay | NO | YES | NO | NO | | |
| Peru | NO | YES | NO | NO | | |
| Poland | NO | YES | NO | YES | Refunds are limited to certain taxpayers and circumstances. Others must carry forward the excess. Interest is paid on late refunds | YES |
| Portugal | NO | YES | NO | YES | Refunds are limited to certain taxpayers and circumstances. Others must carry forward the excess. Interest is paid on late refunds | |
| Romania | NO | YES | NO | YES | Refunds are limited to amounts of ROL 50 million or more. Interest is paid on late refunds | |
| Russia | NO | YES | NO | YES | The excess must be carried forward for 3 months | |
| Singapore | NO | NO | YES | N/A | Interest is paid on late refunds at 2.13% a year | YES |
| Slovak Republic | NO | YES | NO | YES | Carry forward is for 1 period | |
| Slovenia | NO | YES | NO | YES | Refunds are limited to certain taxpayers and circumstances. Others must carry forward the excess to the end of the year | YES |
| South Africa | NO | NO | YES | N/A | Interest is paid on late refunds at 10.5% a year | |
| Spain | NO | YES | YES | YES | A taxable person may carry the excess forward for up to 4 years | |
| Sweden | NO | NO | YES | N/A | | |
| Switzerland | NO | NO | YES | N/A | | YES |
| Trinidad and Tobago | NO | NO | YES | N/A | Interest is paid on late refunds at a rate of 1% a month. | |
| Turkey | NO | YES | NO | YES | Refunds are limited to certain taxpayers. Others must carry forward the excess. | YES |
| United Kingdom | NO | NO | YES | N/A | A taxable person that normally receives refunds may request monthly returns | YES |
| Uruguay | NO | YES | NO | NO | | |
| Zambia | NO | NO | YES | N/A | Interest is not paid on late refunds | |

countries either require the taxable person to offset the credit against future VAT payments or against other taxes. Most of these countries do permit a refund to certain categories of taxpayer or in certain circumstances (for example, if offset is unlikely) or after a period.

Recovery of Foreign VAT by Taxable Businesses

International businesses often incur VATable expenditure in countries where they are not resident. Some nonresidents may incur significant amounts of VAT, especially those that buy and sell goods in another country.

Of the 62 countries surveyed in the *Worldwide VAT & GST Guide*, only 29 countries refund VAT to nonresidents (Figure 12). All of the 25 EU member states refund VAT to nonresidents, as do Bulgaria, Japan, Norway and Switzerland. Romania and Turkey and other European countries that wish to join the European Union could join this list in the near future, as a precondition of their EU membership applications.

Some EU countries restrict refunds to claimants established in countries that provide reciprocal tax refunds (Figure 13). However, many EU countries refund VAT to all nonresident businesses including Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Luxembourg, Netherlands, Sweden and the United Kingdom. VAT recovery is generally available to nonresidents for the same expenditure as may be recovered by residents. In practice, this rule restricts VAT claims for business travel costs in some countries. VAT planning may help to reduce or avoid irrecoverable VAT costs in countries that do not refund tax to

nonresidents. For example, nonresidents may register for VAT to recover VAT in the same way as resident businesses in some countries, including Australia and Italy. However, to secure recovery, action must generally be undertaken before any expenditure is incurred.

Even where VAT refunds are available, nonresident claimants may suffer significant cash flow delays. Most EU countries repay VAT within a six-month period. However, refunds are commonly delayed for far longer periods in some countries, including Italy and Portugal. Some states pay government-rate interest on delayed VAT refunds, but many do not. Nonresidents doing business in many countries may, therefore, suffer considerable additional costs compared with residents.

Figure 12. Countries that Refund VAT to Nonresident Businesses

| | |
|----------------|-----------------|
| Austria | Latvia |
| Belgium | Lithuania |
| Bulgaria | Luxembourg |
| Cyprus | Malta |
| Czech Republic | Netherlands |
| Denmark | Norway |
| Estonia | Poland |
| Finland | Portugal |
| France | Slovak Republic |
| Germany | Slovenia |
| Greece | Spain |
| Hungary | Sweden |
| Ireland | Switzerland |
| Italy | United Kingdom |
| Japan | |

Figure 13. Countries that Provide Reciprocal Tax Refunds

| | EU Countries | Refunds to Business Resident in | |
|-----------------|--------------|-----------------------------------|--------------------------------------|
| | | Non-EU Countries (If Reciprocity) | Non-EU Countries (If No Reciprocity) |
| Austria | Yes | Yes | Yes |
| Belgium | Yes | Yes | Yes |
| Cyprus | Yes | Yes | No |
| Czech Republic | Yes | Yes | No |
| Denmark | Yes | Yes | Yes |
| Estonia | Yes | Yes | No |
| Finland | Yes | Yes | Yes |
| France | Yes | Yes | Yes |
| Germany | Yes | Yes | Yes |
| Greece | Yes | Yes | No |
| Hungary | Yes | Yes | No |
| Ireland | Yes | Yes | Yes |
| Italy | Yes | Yes | No |
| Latvia | Yes | Yes | No |
| Lithuania | Yes | Yes | No |
| Luxembourg | Yes | Yes | Yes |
| Malta | Yes | Yes | No |
| Netherlands | Yes | Yes | Yes |
| Poland | Yes | Yes | No |
| Portugal | Yes | Yes | No |
| Slovak Republic | Yes | Yes | No |
| Slovenia | Yes | Yes | No |
| Spain | Yes | Yes | No |
| Sweden | Yes | Yes | Yes |
| United Kingdom | Yes | Yes | Yes |

Issues and Trends

Distortions of Competition

Wide VAT rate differences may encourage final consumers to shop in countries with the lowest rates. Until recently, however, cross-border shopping was not practical for most consumers. E-commerce has changed that reality. Throughout the world final consumers now have ready access to goods and services that may be provided remotely. This trend is significant for businesses and for final consumers. It may also have serious implications for some tax authorities in maintaining their revenue bases.

Standard Rates

Standard rates of VAT vary widely within the EU. Competition from neighboring countries with lower VAT rates may have spurred the recent announcement by the government of Hungary that it plans to reduce its standard rate of VAT by 5% to 20% with effect from 1 January 2006. Lower VAT rates may also play a role in attracting foreign direct investment (FDI). Luxembourg, which applies the lowest VAT rate in the European Union, at 15%, was the recipient of the greatest amount of FDI in 2002 and 2003.¹¹

Comparison with 2003

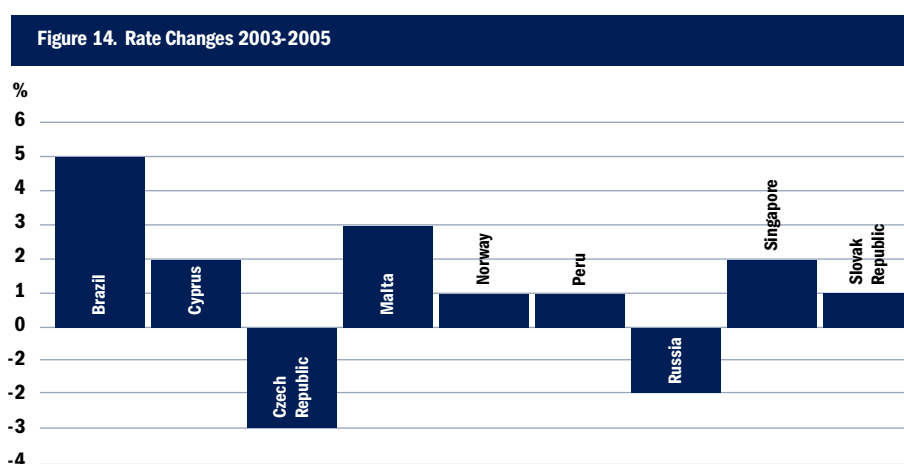
Standard VAT rates have remained the same since 2003 in most countries

worldwide (see Figure 14). Changes in that period were noted in only 9 of the 62 countries surveyed. In seven of the nine countries with rate changes, the tax rate increased; in most cases, modest rises applied (from 1% to 3%). One of the largest effective increases applied in Singapore, where the sales tax rate went from 3% to 5% over a two-year period. However, even after this increase, Singapore maintains the lowest tax rate worldwide.

Rate changes applied in four of the member states that joined the EU on 1 May, 2004; the changes were a direct result of the countries' accession to the Community. Further changes are likely in the EU. Since this study was undertaken, rate increases have taken effect in Greece and Portugal. Hungary has announced a possible rate decrease in 2006.

Reduced Rates

It is also important to consider the impact of reduced rates on cross-border shopping. Assuming that all other price factors are equal, small VAT rate differences between countries may not generally influence consumer behavior. However, the picture may change if the reduced rates are considered. For example, the standard rates that apply in Germany and the United Kingdom are very close, at 16% and 17.5% respectively; a far wider difference exists between the countries' lowest reduced rates, which are 7% in Germany and 0% in the United Kingdom. This greater rate difference could influence where consumers purchase reduced rated goods, especially for items that are readily available from online retailers, such as books.



¹¹ "World Investment Report 2004: The Shift Towards Services" United Nations Conference on Trade and Development (UNCTAD)



The rate comparison may be even more extreme for items that are subject to the standard rate in some countries and to the reduced rate in others. This treatment applies in practice to a wide variety of items, including nonperishable foodstuffs, CDs, books, raincoats and children's clothing. Businesses that sell goods in these tax categories may be particularly vulnerable to the competitive effects of different VAT rates.

Cross-Border Shopping

For most transactions in goods, however, the VAT rate is "neutralized" at the border. VAT does not apply to export sales and does apply (at the local rate) to imports. The effects of cross-border shopping are most keenly felt, therefore, when goods and services may be traded between countries or regions with different tax rates but no borders. This situation may arise in countries with state-based VAT systems, such as Brazil and India, or in borderless trading blocs, such as the EU.

The EU has tried to counteract the worst impacts of this type of distortion by applying special rules to "distance sales." Under these rules, an EU vendor must register for VAT in any EU country where its annual distance sales exceed certain limits. This system is very cumbersome for sellers to operate. Also, taxpayer compliance is difficult for tax administrations to enforce.

However, in the absence of any real harmonization of EU VAT rates, the distance selling rules seem likely to remain in place.

The EU has tackled this issue for B2C services received from outside the European Union. Member states were becoming increasingly concerned about EU consumers using their computers to purchase software, entertainment and other services from suppliers located outside the EU, thereby avoiding VAT. The Community recently introduced rules imposing VAT on B2C services supplied electronically from outside the EU. Under the new rules, non-EU service providers must register for VAT and charge VAT at the rate that applies in the EU customer's country. Some inequalities continue, although now the potential for inequality has been tipped towards EU businesses. B2C services supplied within the EU are generally taxed at the VAT rate applicable in the supplier's country. Therefore, EU customers may still effectively cross-border shop for many remote services, at least within the Community.

To ease compliance, the Community has also introduced a one-stop-shop approach to multi-country registration in these circumstances. However, this approach is not yet available for transactions in goods.

For most B2C services, under the EU place of supply rules, tax currently applies in the supplier's country. This rule may help businesses established in EU member states with low rates to attract customers from higher rate countries. Non-EU service providers may also take advantage of this rule for sales to EU consumers, by setting up a place of establishment in a low-rate country, such as Cyprus or Luxembourg. Until recently, a further rate arbitrage was available for suppliers established in the Portuguese Autonomous Regions of Madeira or the Azores where a 12% rate applied. However, with effect from 1 July 2005, the standard rate in these regions has increased to 15%, which equals the lowest EU standard rate applied elsewhere.

E-Commerce Compliance

A major difficulty for governments in protecting tax revenues arising from e-commerce sales is in achieving taxpayer compliance. Different countries have approached this issue in different ways. Some countries impose a requirement for local entities to act as tax agents for B2B transactions. This approach is less successful for transactions involving private consumers B2C. In these cases, VAT registration may be required for the nonresident entity or nonresidents may be required to appoint tax intermediaries or an agent.

The OECD's recent report on e-commerce compliance issues¹² recognizes that widespread compliance by business relies on governments adopting business-friendly policies in this area:

“Overall, the report concludes that tax administrations should make it as simple as possible for suppliers to comply within a secure and effective tax collection framework. Tax compliance in cross-border B2C e-commerce will operate successfully only if tax administrations provide a supportive environment.”

Possible business-friendly solutions put forward by the OECD include the wider use of electronic VAT returns, the use of VAT intermediaries and the adoption of approved VAT accounting software.

Place of Supply of Services – OECD Approach

All countries apply exemption with credit to exports of goods to allow tax neutrality. However, in practice, exemptions may not always apply to “exported services.” Different VAT regimes apply very different rules to apply tax to services – no universal place of supply rules exist. International agreement on the VAT treatment of transactions is generally restricted to specific trading blocs, such as the European Union. The OECD comments in its recent report:

“The absence of internationally agreed approaches [to indirect taxation] in the area of services and intangibles which, in the past, may be

traced back to a lack of need, awareness or consensus, is now leading to significant difficulties for both business and governments.”

As a result, a cross-border service may be taxed in the supplier's country, in the customer's country, in both places or not at all. Where double taxation does exist, it is hard to eliminate because VAT is not generally provided for in international tax treaties.¹³ Also, the tax charged is often a real cost, even for businesses that are fully taxable persons, as most countries do not repay VAT to nonresidents. For entities that do not recover VAT in full, the burden is even greater and may act as a disincentive to cross border trade.

The OECD comments:

*“Value added taxes are designed to tax final consumption and as such it is only consumers who should bear the economic costs. The Working Party notes that one of the causes of double taxation is the imposition of tax in such a way that services and intangibles are being taxed more than once, with little or no opportunity for deduction or refund. Therefore, it is important to state that in terms of the application of VAT to internationally traded services and intangibles the Working Party is of the view that, **as an underlying principle, VAT should not impose an economic impact on taxable businesses.**”*

“Place of supply” differences that lead to double taxation are particularly costly for exempt and partly exempt

businesses. However, differences in interpretation may also lead to non-taxation or to VAT rate arbitrage opportunities for supplies to these customers, as well as to final consumers. In these situations, considerable competitive advantage may be granted to nonresident service providers, especially for services that are easily delivered electronically. Concerns about non-taxation of services are particularly strong for service suppliers resident in developed countries with no national or federal VAT system at all, including the United States.

Tax authorities have become more aware in recent years of the potential for businesses to acquire services crossborder that were once available exclusively within a domestic market, such as telecommunications or training services. The European Union has responded by extending the reverse charge to a greater range of B2B services in recent years and with its outstanding proposal to extend this rule to all B2B services, with a few exceptions.

The OECD is attempting to resolve the difficulties in this area; its report suggests the following solutions, which involve an increased used of the reverse charge for B2C services and the extension of VAT to international tax treaties:

“The OECD would identify existing problems in certain countries and propose remedies. A more effective form would be a dispute resolution mechanism, but we think that some

¹² *Facilitating Collection of Consumption Taxes on Business-to-Consumer Cross-Border E-Commerce Transactions* copyright Organization for Economic Co-operation and Development 2005

¹³ *“The Application of Consumption Taxes to the International Trade in Intangibles and Services”* copyright Organization for Economic Co-operation and Development 2005

form of binding commitment is necessary to implement such a mechanism in practice (for example, bi- or multilateral convention). The most effective way to solve cross-border mismatches in VAT/GST would be an agreement on the application of consumption taxes, either as part of the existing MTC or as a separate bilateral or multilateral agreement. A general application of the destination principle with as few exceptions as possible, together with a general application of reverse charge for B2B transactions, could minimize the need of cross-border registration and refund claims and therefore disburden companies and authorities alike.”

“We strongly plead for the creation of clear rules, being aware that even under clear rules identifying where services should be taxed can be complex particularly where multinational contracts are involved.”

VAT Risk Management

A growing trend among multinational corporations is a concern about VAT risk management. In part, this change is the result of an increased understanding by multinationals that VAT errors affect profitability. In part, it is the result of the adoption of stricter corporate governance rules in many countries, including the passing of the Sarbanes-Oxley Act (SOX) in the United States in 2002. For most multinational corporations the VAT account is a

“significant account” for purposes of Section 404 SOX.¹⁴

This increased emphasis on risk management applies to all taxes, but VAT plays a particularly important role because of the large amounts of VAT handled by taxable persons on a daily basis. VAT applies to inputs as well as to outputs. Therefore, the percentage of gross income that VAT represents for a taxpayer is far higher than the average VAT rate, and a far higher percentage than other taxes that are calculated on profits or gains.

The potential for error is also high. Correct VAT decisions must be applied to almost every item of income and expenditure. Significant VAT errors may lead to regulatory issues, severe financial penalties and adverse publicity. However, given the complexity of the tax in many areas, errors in VAT accounting may easily occur. When multiplied across a large number of transactions, even small errors may result in significant risks. For example, a multinational corporation with an accounting error rate of just 1% risks a VAT under-declaration rate of \$10 million for every \$1 billion of VAT throughput (that is, VAT on gross income and expenditure). In practice, few corporations have VAT error rates this low.

In response, multinational corporations are paying greater attention to accuracy in their VAT accounting. Many taxpayers have increased their in-house resources to manage indirect taxes and have invested in software to cope with

tight deadlines and multiple VAT regimes, to increase in-house knowledge and to identify errors before external tax audits. Some corporations have chosen outsourcing solutions for VAT return submission, to take advantage of the knowledge, experience and resources of external specialists. They are also taking greater steps to identify VAT errors and to provide for them in their accounts.



¹⁴ Sarbanes Oxley Act Section 404: Management Assessment of Internal Controls.

Conclusion

Tracking and assessing the impact of VAT and consumption taxes on a multinational is one of the many factors that tax directors and chief financial officers need to take into account when assessing overall business performance.

This report provides a snapshot of the current range of worldwide VAT rates and VAT compliance requirements, as well as some of the underlying VAT issues and trends that multinationals face in doing business around the world. It illustrates the wide differences that exist between countries in applying consumption taxes and is part of Ernst & Young's commitment to working with its clients around the world in assessing the global tax environment in which today's companies operate.

Further information on Ernst & Young's *Worldwide VAT & GST Guide 2005* may be found at www.ey.com/tax or through your local Ernst & Young contact.

“ ...part of Ernst & Young’s
commitment to working
with its clients around
the world in assessing
the global tax
environment...” ”

**“ Indirect tax is often
the forgotten tax on
business. ”**

“ More often than not finance directors view indirect tax as a process-oriented throughput cost rather than as a direct charge to the bottom line. ”

Country Contacts

Australia

Greg Hill
Telephone: [61] (2) 8295 6432
Email: greg.hill@au.ey.com

Canada

Irene David
Telephone: [1] (416) 943 3062
Email: irene.j.david@ca.ey.com

China/Hong Kong

Adrian Ball
Telephone: [852] 2629 3810
Email: adrian.ball@hk.ey.com

France

Patrick Donsimoni
Telephone: [33] (1) 46 93 48 70
Email: patrick.donsimoni2@ey-avocats.com

Germany

Christa Breucha
Telephone: [49] (711) 9881 15244
Email: christa.breucha@de.ey.com

Hungary

Robert Heinczinger
Telephone: [36] (1) 451 8262
Email: robert.heinczinger@hu.ey.com

Japan

Marc Bunch
Telephone: [81] (3) 3506 3893
Email: marc.bunch@jp.ey.com

The Netherlands

Gijsbert Bulk
Telephone: [31] (20) 549 7218
Email: gijsbert.bulk@nl.ey.com

South America

Frank de Meijer
Telephone: 55 11 3523 5413
Email: frank_de.meijer@br.ey.com

Switzerland

Philip Robinson
Telephone: [41] (58) 286 31 97
Email: philip.robinson@ch.ey.com

United Kingdom

Robert Crooks
Telephone: [44] (161) 333 2815
Email: rcrooks@uk.ey.com

United States

Gary LeDonne
Telephone: [1] (212) 773 3681
Email: gary.ledonne@ey.com

United States VAT Desk

Robin Maxwell
Telephone: [1] (212) 773 3350
Email: robin.maxwell@ey.com

For other countries please visit www.ey.com or see your regular Ernst & Young contact.

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