Indirect taxes are evolving. Are you?

Discover how to better manage indirect taxes.

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The better the question. The better the answer. The better the world works.
Global retail e-commerce sales
(in US$ trillion)

The tax of the moment

Indirect taxes are part of everyday life in many countries – we pay them on food, clothing, gasoline, vices such as alcohol and chocolate, and our mobile phones.

The levies have long been popular because governments don’t have to wait for a business to generate a profit to collect a tax; all that needs happen is for a transaction to occur. Going forward, technology will further boost their popularity as digitalization has positively impacted the administration of these taxes.

For consumers, value-added taxes (VAT) and goods and services taxes (GST) – present in more than 160 jurisdictions – are the most common and visible touch-points.

Businesses, however, must deal with a wide swath of indirect levies including excise taxes, customs duties, carbon taxes and more. And this list will continue to grow with the expansion of global trade as well as global trade agreements, adding more layers of complexity to the indirect tax compliance labyrinth.

In theory, the typical indirect taxes (VAT) are designed to be a cost to business only to the extent they are the end user of the good or service, with an offset or credit in their supply chain/production. However, businesses must carefully manage these costs as unclaimed VAT offsets or disputed VAT refunds could hurt profitability. In fact, businesses identified indirect taxes as their No. 2 overall source of risk in the most recent EY Tax Risk and Controversy Survey Series, behind only transfer pricing.

The “go-to” tax

The global taxation system is currently undergoing an unprecedented transformation, and indirect tax is well placed to become the “go-to” source of tax revenue for governments in the future.

For example, countries around the world are currently implementing recommendations by the Organisation for Economic Co-operation and Development (OECD) to prevent so-called base erosion and profit shifting (BEPS) of income. These changes are expected to bring increased transparency but greater controversy as well. Taxation on profits will continue to grow with the expansion of global trade as well as global trade agreements, adding more layers of complexity to the indirect tax compliance labyrinth.

Investing in the future

This is not to say indirect tax administration is perfect – far from it. Tax administrations in many jurisdictions struggle to deal with indirect tax fraud. The European Union, for example, estimates it lost 151.5 billion euros in VAT in 2015.

In response, tax administrations have established many complex and costly compliance requirements, and as a result businesses today often face substantial delays in obtaining VAT/GST refunds or credits. Others wind up receiving nothing, with some finding the compliance requirements sooner that they don’t even bother filing for refunds.

Automation and technology promise to help businesses better manage the complex and often lengthy process of claiming indirect tax refunds. But this will require businesses to invest in their own tax departments, including in the area of robotic process automation, in order to make the tax function more efficient and free up employees to focus on value-added activities. And investments in technology will support growing compliance demands created by new government initiatives that track VAT/GST-related transactions in real-time through e-invoicing, blockchain or other innovations.

Digital questions

Controversy may also be set to increase in the indirect tax space thanks to looming digital issues.

Just as in the income tax space, indirect tax officials are wrestling with fundamental questions and taking different approaches on what to tax and where in the digital economy.

Tax administrations are increasingly focused on collecting due VAT/GST from business-to-consumer as well as business-to-business digital transactions, adapting and introducing legislation to collect these indirect taxes in the country in which the consumer is based.

Changes in the approach to taxation of e-commerce transactions poses an increased risk of double-taxation in the indirect tax space, something that historically was a bigger concern in the profit tax arena. Businesses need to keep up and comply with changing tax laws for digital transactions – an admittedly challenging task considering the current pace of change.

Investing in both people and technology will enable businesses to anticipate and resolve controversy and to monitor fast-changing developments in critical markets.

It’s a new era for indirect taxation and businesses need to prepare for this new landscape. In our globalized, digital world economy, indirect taxes are the tax of the moment.

P.S. – Tax Insights is going digital only

Tax Insights for business leaders is also adapting to the digital era. This is the 20th edition of our magazine – and my seventh editorial. It is also our last issue – on paper.

The goal of Tax Insights is to examine and discuss the complexities of global taxation so that a wider array of business executives can understand rapidly-evolving developments in key areas of taxation.

We invite you to join us on a journey as we shift from publishing a print magazine three times a year to focus on our digital content hub at taxinsights.ey.com. To keep completely up to date, we urge you to subscribe to our e-newsletter. We’ve been proud to serve our readership over most of the last decade and hope you’ll join us in this transition.

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“VAT/GST systems have encountered significant instances of fraud over the years – and tax administrations recognize they are still susceptible today.”

Michael Keen
Deputy Director, Fiscal Affairs Department, International Monetary Fund

SEE PAGE 28
Indirect taxes

> **Indirect tax** is no longer a bureaucratic exercise, but a strategic focus for the tax function today.
Over recent decades, **indirect taxation** has become increasingly appealing to governments. The “tax of the moment” keeps evolving to keep pace with technological innovation, global tax reform, shifting trade patterns and policies, and new governmental priorities for health and the environment. Businesses need to pay attention — this tax has staying power.

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**Going global — general consumption taxes**
Imagine a world without taxes on clothes, food or movie tickets. Less than a century ago, general consumption taxes on goods and services did not exist. France kicked off a new indirect tax era by introducing the first value-added tax (VAT) in the early 1950s. By 2016, VAT and goods and services tax (GST) could be found in more than 160 jurisdictions worldwide, according to the Organisation for Economic Co-operation and Development (OECD).

**Taxing digital goods**
The explosion of internet shopping created a tax revenue headache for governments. As existing laws didn’t address this new model of consumption, tax administrations found themselves shortchanged when it came to collecting VAT and GST on online goods and services. Many governments around the world, through their own efforts as well as those of the OECD, are introducing reforms to make sure their indirect tax systems are fit for the internet age.

**Expanding “sin taxes”**
Alcohol, cigarettes and fuel have been the traditional targets of levies known as excise taxes. Governments are now adding new “sin taxes,” as they seek to influence consumer behavior and collect more tax revenue, including sugar taxes on soft drinks and other products to fight obesity, and environmental taxes to curb carbon emissions.

**Upgrading indirect tax systems**
The days of paper forms and manual spreadsheets are almost over. During the past decade, tax administrations around the world have introduced new software, processes and requirements to move indirect tax into the digital age. The goal is to become smarter and more efficient, reducing the amount of indirect taxes lost to fraud, inefficiencies and other issues.

**Evolving trade policies**
The global financial crisis a decade ago altered the course of globalization. Open borders have been replaced by a more cautious mindset and protectionism. Free trade agreements are on the decline and temporary trade barriers are on the rise. More governments could choose to alter their import duties and customs tariffs going forward.

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“We see huge possibilities opening up as the UK strikes free trade agreements with non-EU states.”

Michael Collins
Chief Finance Officer and Deputy Chief Executive Officer, LacPatrick

SEE PAGE 25
US tax reform: looking forward and leading the way
Read our analysis and insights concerning the biggest US federal income tax reform in more than three decades.

Blind curve or ahead of the curve?
The Organisation for Economic Co-operation and Development’s multilateral instrument provides a way for jurisdictions to rapidly implement tax reforms. This video explores when and how it will affect businesses.

Looking back and ahead: are you ready for 2018?
The webcast – the final in a four-part series – takes stock of an evolving global tax environment and discusses what businesses can expect in 2018. 

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The rise and rise of indirect tax

The indirect tax world is experiencing an unprecedented era of expansion and transformation, forcing businesses to prioritize how these levies are managed and paid. We began to see the rise of indirect tax at the turn of the millennium, specifically value-added tax (VAT) and goods and services tax (GST), as well as special consumption taxes on items such as cars, cigarettes and alcohol.

Consumption taxes as a percentage of total tax revenue have remained stable across members of the Organisation for Economic Co-operation and Development (OECD), with an average of 30.5% in 2014 compared with 30% in 2004. But these taxes are being applied to an ever-widening range of products and services. Some of the most recent examples include new levies on sugar, carbon emissions, plastic bags, e-cigarettes, along with goods and services sold online.

The compliance burden has expanded in tandem. This represents a significant challenge and risk for the tax function today considering the wide range of detailed data and technological processes required by each jurisdiction, not to mention the perpetual revisions in indirect tax policies.

All of these developments have led to indirect tax assuming a key role in strategic planning within the tax function. Global businesses need to monitor indirect tax developments closely. And they should be prepared to adapt their transactions, accounting policies and technology in order to pay and recover the correct amount of tax.

(Follow changes to VAT, GST and other indirect taxes with the EY Worldwide Indirect Tax Developments Map at www.ey.com/indirecttax).

Globetrotting tax
While customs duties have been around a long time (in medieval Germany, people paid customs duties to use the roads and bridges), general taxes on goods and services are a modern phenomenon. France was the first country to introduce a general consumption tax, in this case VAT, in the early 1950s. It took a few decades to catch on – in the late 1960s only 10 countries had introduced a VAT or GST, according to the OECD – but by 2016 some 166 jurisdictions across the world had one.

The OECD calls VAT “among the most important developments in taxation over the last half century.” Governments like VAT/GST for a few reasons: it’s a stable source of revenue, especially in times of recession; it’s efficient to levy in terms of costs and time; and it tends to weigh less on economic growth than other taxes.

Globalization has also boosted the appeal of this tax. As global trade took off in the 1990s and more jurisdictions opened up their borders via free trade agreements, many developing countries introduced a VAT/GST to compensate for lower trade duties and tariffs, according to the OECD.

The adoption of VAT/GST has altered the mix of taxes collected by governments, shifting from specific to general consumption. Excise taxes on specific goods and services declined to 7.6% of total tax revenue, on average, among OECD member countries in 2014 compared with 14.2% in 1965. In contrast, general consumption taxes raised 20.7% of total tax revenue on average among OECD members in 2014, up from 11.9% in 1965.

See how they rise
Recent years have ushered in further changes to indirect tax policies. The 2008 financial crisis and accompanying global recession led to a decline in corporate profits and tax revenue raised by governments. Jurisdictions first responded by addressing corporate tax practices that shrank their tax revenue. The OECD’s base erosion and profit shifting (BEPS) plan, currently being rolled out across the world, is one such initiative.

But attention soon shifted to indirect tax, which proved to be an important tool for governments battling the aftermath of the global financial crisis. Some countries increased their VAT/GST rates in order to raise additional revenue. In the European Union (EU), for example, average VAT rates have increased since 2008. Other jurisdictions extended exemptions and reduced rates for additional goods and services.

The spread of VAT/GST to new jurisdictions continues. India introduced its new GST system in 2017, and Saudi Arabia, the United Arab Emirates and other countries within the Gulf Cooperation Council will introduce a new VAT in 2018.

For now, it appears that VAT/GST rates are unlikely to further increase, but will instead stabilize at current high levels or may even decline in some jurisdictions. The only exception is in the area of online goods and services as governments introduce new measures...
or clarify existing rules to collect indirect tax revenue that has until now largely slipped through the cracks. For example, some countries are abolishing tax exemptions for small online shipments.

**The new excise taxes**
Excise taxes on specific goods also remain an important source of tax revenue for governments, although they too are evolving. While excise taxes on alcohol, cigarettes and fuel are applied widely across the world, many others vary from market to market, covering everything from chewing gum to jewelry.

New excise taxes are being used to influence consumer behavior, such as sugar taxes on soft drinks to fight obesity or carbon taxes to address pollution.

By using different tax rates or treatments to encourage consumers to switch to “less harmful” versions of some products, excise tax policies can also play a role in stimulating innovation and creating a market for fledgling technologies.

Along with growing compliance requirements, these changes in excise taxes and VAT/GST influence the business itself. A new sugar tax, for example, could affect prices and demand and ultimately the profitability of the business. Producers and sellers of taxed products may need to innovate or diversify to maintain profitability.

**Closing the tax gap**
Governments today have other avenues available to collect more indirect tax revenue. When it comes to transactional taxes like VAT/GST and customs duties, vast quantities of data are produced each day. Tax administrations are digitalizing their indirect tax systems in order to increase transparency and efficiency and reduce errors.

One of the main goals is to narrow the so-called VAT/GST gap – the tax loss to fraud, inefficiencies and other issues. In the UK alone, the VAT gap was estimated at £12.2 billion, or 9.6% of estimated net VAT, in 2015–2016.

In some jurisdictions today, taxpayers are expected to submit indirect tax data automatically and electronically. Spain, for example, introduced a new “Immediate Submission of Information” (ISI) system in 2017, requiring businesses that file VAT returns on a monthly basis to electronically keep their VAT books through the new system. China, Russia and Brazil, which are all wrestling with large VAT/GST gaps, are also successfully deploying digital systems to gather more indirect tax revenue.

Software tools provide another way for tax administrations to identify indirect tax errors, uncover issues with taxpayers’ enterprise resource planning (ERP) systems and conduct risk-based audits. Technology also allows tax and customs administrations to share information, for example through joint risk assessments, which provides them with greater insight and transparency into taxpayer filings.

**The right approach**
Taxpayers can’t afford to lag behind tax administrations in this digital transformation. Investing in technology, including moving to standardized, automated processes instead of relying on manual spreadsheets, will help businesses handle greater quantities of data and comply with more demanding indirect tax reporting requirements.

Such efforts will also help businesses respond more effectively if they come under increased scrutiny by tax authorities. And it should help lower costs for headcount, cash flow, consulting, accounting and compliance.

By digitalizing their indirect tax systems, businesses can gain greater visibility over their indirect tax obligations and risks, including outstanding VAT/GST refunds. In some countries, especially those dealing with significant VAT/GST gaps, it can be extremely difficult to obtain such refunds. This waiting game can transform VAT/GST recovery into a significant cost for the business – a risk that eventually is brought to the attention of the C-suite.

Digitalization can also lead to less business disruption. Digitalized tax administrations are moving toward a system in which they will be able to identify and certify taxpayers who are compliant. Tax administrations would no longer have to analyze all taxpayers – compliant and noncompliant – in the same manner. Those deemed “good” would face less scrutiny and fewer audits.

In an era when the popularity of indirect tax keeps rising, the onus is clearly on businesses today to pay greater attention to governments’ favorite “child.”

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The excise evolution

Excise taxes are popular with governments today because they are easy to collect and relatively recession-proof. Now the list of excise taxes is expanding beyond the traditional cornerstones of alcohol, tobacco and fuel.
Excise taxes have been around so long, it is tempting to think of them as a historical legacy. But there is nothing antiquated about them—they are a major revenue generator for governments today and becoming more popular by the year.

Take the US, where state excise taxes on motor fuel, insurance, tobacco, alcohol and other products totaled US$140 billion in 2014—three times the amount that states raised from corporate income tax. Excise taxes collected by US states increased 4% on average between 2010 and 2014, according to EY data.

This growth in excise tax revenue is mirrored in many other countries across the world as policymakers are lured by the prospect of easy collection—commodities such as salt, tobacco and alcoholic drinks have been subject to excise taxes for centuries in Asia, Europe and elsewhere. Excise taxes also tend to be less affected by economic fluctuations, including the global financial crisis a decade ago.

In 2013, excise taxes among members of the Organisation for Economic Co-operation and Development (OECD) and six selected African countries raised US$1.03 trillion, according to an EY analysis. That was 68% of the value of corporate income tax collected in the same time frame, and nearly half the amount raised through value-added tax (VAT).

Today, excise taxes are emerging as the newelixir for policymakers. Governments are using them to sustain tax revenues in a world of changing monetary, fiscal and trade policies and to cover the external costs related to the use of certain goods and services. By the end of 2017, for example, the six members of the Gulf Cooperation Council (GCC) – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE) – were to introduce levies for the first time on tobacco, carbonated drinks and energy drinks.

The trend merits close attention from corporate tax executives and policymakers alike who may be focused more on changes to corporate income tax policies.

“Excise tax used to be the stepchild of tax policy and got very little attention,” says Siibren Cnossen, Professor Emeritus at Erasmus University in Rotterdam. But he says this is changing as governments and people increasingly understand the external costs certain goods or services can impose on a society.

Different approaches to taxation
Tobacco, alcohol and fuel have traditionally formed the cornerstones of excise taxes, although the decision on which goods to tax and by how much varies widely from country to country, including among member states of the European Union (EU). Grape-growing countries such as Italy, Portugal and Spain have no excise on wine, for instance. But further north, taxes on alcohol tend to rise. In Norway, excise on wine is US$7 a liter, according to the OECD’s Consumption Tax Trends 2016.

Hard liquor tends to be more heavily taxed. Iceland’s excise on spirits reaches US$104.62 per liter of pure alcohol, more than ten times the level in the US and Canada, according to the OECD.

Tobacco taxes also vary greatly among OECD members. Many countries impose an ad quantam excise tax per 1,000 cigarettes and an ad valorem excise tax based on price, then top these off by imposing a VAT or sales tax. This triple tax whammy is designed to ensure tobacco taxes are high and rise with inflation. The OECD calculates that among member states the total tax burden as a percentage of the average retail sales price ranges from 42.5% in the US to 86.5% in Ireland.

“Taxing motor fuel, alcohol and tobacco is attractive because the taxes are relatively easy to collect,” says Walter De Wit, a senior member of EY’s Global Trade practice. “You can collect them from a relatively small number of companies, and easily work out how much they owe you.”

Along with considerations about how local industries and jobs could be affected by excise taxes, governments often make moral judgments when determining excise taxes. And jurisdictions with porous borders must also consider how big differences in rates could lead to smuggling and related crime.

Tax codes suggest that “wine is the drink of moderation; beer is the drink of the common man; spirits are bad.”

Emil Sunley
Senior Advisor for the International Tax and Investment Centre

Many tax codes suggest that “wine is the drink of moderation; beer is the drink of the common man; spirits are bad,” says Emil Sunley, a Senior Advisor for the International Tax and Investment Center and retired Assistant Director in the Fiscal Affairs Department of the International Monetary Fund.

Expanding list
The list of goods with excise taxes keeps expanding. The list now includes chocolate, coffee, mobile phones, plastic bags and soft drinks to name but a few.

Excise policymakers used to target goods viewed as luxuries. Now, data and analytics are making it possible to quantify the negative effects from an individual or group’s behavior, which is transforming the excise landscape.

“When we do certain things, like smoking, drinking or polluting, we impose costs on other people, on society,” says Cnossen. “These costs are not accounted for in the price. The excise is the instrument to do that.”

Economists call these “external” costs. Smokers, for example, can fall ill, or their smoke can irritate and harm others.

The excise taxes also cover the cost of two complementary strategies deployed by governments to discourage so-called anti-social behavior: regulation and public education. In many countries, the number of smokers is now declining.
Sugar taxes around the world*

*Countries that have introduced or plan to introduce taxes on sugar, including sugar-sweetened beverages (SSB)

- The UK is set to introduce a tax of 18 pence per liter on soft drinks with more than 5 grams of sugar per 100ml, and 24 pence per liter on soft drinks with higher levels of sugar in April 2018.
- France first introduced a tax on SSBs in 2012, and plans to increase the tax to 20 euros per hectoliter for drinks that contain more than 11g of sugar per 100ml.
- Portugal introduced a tax on soft drinks in 2017. There is a tax of 16.46 euros per 100 liters on soft drinks with more than 80 grams of sugar per liter, and a tax of 8.22 euros per 100 liters on soft drinks with lower levels of sugar.
- Spain’s Catalonia region introduced a tax on sugary soft drinks in 2017.
- Belgium increased its tax on sweetened drinks in 2016 to 0.068 euros per liter.
- Finland introduced a tax of 0.95 euros per kilogram on sweets and ice cream in 2011, but the European Commission said the tax system was unfair because imported sweets were also subject to import duties. Finland scrapped the tax on candy in 2017, though a tax on nonalcoholic sugary beverages remains in place.
- Hungary introduced a tax on food with high levels of sugar, fat and salt along with higher tariffs for soft drinks in 2011.
- Ireland plans to introduce a tax on sugary drinks in 2018 of 30 cents per liter on beverages with more than 8 grams of sugar per 100ml, and 20 cents per liter on beverages with 5–8 grams of sugar per 100ml.
- Vietnam plans to introduce a special sales tax on soft drinks in 2019.
- Fiji announced plans in 2017 to increase taxes on SSBs by 15% to 35 cents per liter.
- Kiribati introduced a 40% tax on sweetened drinks in 2014.
- Tonga introduced a tax on SSBs of 1 Pa’anga per liter.
- Vanuatu introduced a tax on SSBs of 50 Vatu per liter in 2015.

- Brunei introduced a US$0.29 per liter tax on soft drinks in April 2017.
- In Thailand, taxes on sugar-sweetened beverages range from US$0.15 to US$1.33 per liter.
- Laos has an 5%–10% ad valorem tax on soft drinks, soda, fruit juices and energy drinks.
- Cambodia levies a 10% ad valorem tax on imported beverages.
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South Africa will introduce a tax on sugary beverages in 2018.

Mauritius introduced a tax on soft drinks in 2013, and extended the tax in 2016 to all sugar-sweetened nonalcoholic beverages.

The GCC Members agreed to introduce a 50% ad valorem excise on carbonated drinks by the end of 2017.

Mexico introduced a 1-peso-per-liter tax on SSBs in January 2014.

In the US, the first tax on SSBs was introduced in March 2015 in Berkeley, California (US$0.01 per fluid ounce). Other US cities have also begun taxing soft drinks including Seattle, Washington; Philadelphia, Pennsylvania; Boulder, Colorado; Oakland, California.

Chile introduced an ad valorem tax on sugary drinks in 2014, and increased it in 2015 to an 18% ad valorem tax on drinks with more than 6.25 grams of sugar per 100ml in 2015. A 10% tax is levied on beverages with lower levels of sugar.

Ecuador introduced a SSB tax of USD$0.18 per 100g of sugar per liter.

Barbados introduced a 10% excise tax on SSBs in 2015.

Dominica introduced a 10% excise tax on SSBs and food with high levels of sugar, including chewing gum and chocolate in 2015.

Sugar: the new “sin” tax

Britain’s new sugar tax won’t take effect until April 2016, but it is already changing behavior. Soda manufacturers are reducing sugar in their products by up to 50% to escape the tax. That’s good news for the UK government in terms of health policy, although less so on the tax revenue front. The Office for Budget Responsibility predicts revenue from the tax will be only £380 million, 27% less than forecast.

Philip Hammond, UK Chancellor of the Exchequer, has said he is “delighted” to see the tax making an impact amid a national obesity epidemic. The UK is one of many countries around the world that are introducing excise taxes on soft drinks and other products containing high levels of sugar to try to address rising obesity rates. A single can of soda can contain as much as 10 teaspoons of sugar, according to the World Health Organization, more than the maximum recommended daily intake of 6 teaspoons of free sugar.

In Mexico, for example, sales of sugary drinks declined for two years in a row after the government imposed an excise in 2014 on carbonated soft drinks, fruit drinks and iced teas. The six states of the Gulf Cooperation Council will introduce a 50% ad valorem excise on carbonated drinks by the end of 2017, affecting 54 million people.

Indirect taxes

A round the world, excise taxes send many contradictory messages to car buyers, car users and car makers. Cars have long been a favorite target of tax authorities. Many jurisdictions tax their purchase via a registration tax. Others impose a road tax on their use, tolls on bridges and highways and taxes on company cars. Fuel taxes are also a big source of revenues and are easily collected since there are only a few producers.

Governments have many justifications for such taxes: drivers have accidents, clog the roads, and emit greenhouse gases, undermining the quality of life for everyone else. Along with using excise taxes to cover the external costs to society, governments can also offer tax credits to support the development of greener, more efficient vehicles.

In the US, for example, buyers of plug-in electric drive vehicles benefit from a tax credit of US$2,500 to US$7,500 (depending on battery size). The tax credit fades progressively once the manufacturer has sold 200,000 vehicles.

Faced with the consequences of global warming, governments now face the challenge of turning these piecemeal tax regimes into a coherent lever to contain carbon emissions. Auto makers, and their customers, are heading for a storm of technology and tax change in the years ahead.

Source: IRS

> Since excise taxes have reduced smoking, policymakers have begun experimenting to see whether they could curb other bad habits. Obesity and diabetes are becoming a global scourge, pushing up health care costs for governments. Hence the new taxes on soft drinks (see pages 14–15) which are aimed at encouraging manufacturers to reduce sugar content and convincing consumers to choose healthier options.

But it’s not always so straightforward. Excise taxes can also trigger a consumer backlash and unintended consequences. Take Chicago’s Cook County, the second-most populated county in the US, which introduced a tax on sweetened drinks during the summer of 2017. It ended up repealing the tax a few months later as consumers bought their groceries in other counties to avoid paying the tax.

“I can see a situation occurring where one county imposes a tax on soft drinks thus incentivizing people to purchase their soft drinks from a store in a nearby or neighboring county that doesn’t impose the tax – and perhaps while the people are visiting this nearby store, they buy the rest of their groceries,” says Ashley Scheele, EY Excise Tax Service Leader based in Houston.

In such a situation, the government in the consumer’s home county or even the country loses the revenue from the excise tax on the soft drinks as well as the sales tax on the rest of the groceries. And the health benefits of the excise tax will not be achieved. In other words, calorie consumption won’t fall if tax avoidance is easy.

Taxing emissions

Perhaps the biggest question that governments are struggling with today is whether excise taxes can fix the world’s carbon emissions problem. Some 170 countries that have ratified the Paris Climate Agreement will decide individually what method they will use to reduce their excess emissions, such as environmental taxes and carbon pricing mechanisms, including cap and trade schemes.

Car users around the world already pay a mix of excise taxes, including a purchase tax, registration or usage tax and fuel taxes. Some jurisdictions offer tax credits to buyers of electric vehicles. Excise tax policies, combined with regulatory targets, are increasingly shaping the strategies of car makers, from the research and development stage through to plant location and marketing.

Professor Cnossen predicts governments will continue to raise and extend excise taxes – to aviation and shipping fuels, for example – as they seek to model the external costs of burning fossil fuels.

Winning support

If new taxes are to win public support, policymakers must tread carefully. Excise taxes tend to be regressive: they swallow a larger proportion of revenue of poorer households at a time when inequality has become a global issue.

“When we do certain things like smoking, drinking or polluting, we impose costs on other people, on society.”

Sjibren Cnossen
Professor Emeritus at Erasmus University in Rotterdam.
For enterprises, too, they pose a challenge. Tax administrations are digitalizing indirect tax systems, including excise taxes, and businesses must be able to comply with new filing and other requirements. As Sam Dagley, a Houston-based Manager in the EY Excise Tax Service team, points out, it is becoming easier to measure sales of goods such as fuel that are taxed by volume – electronically and remotely. In effect, the burden of tax collection is being shifted from revenue authorities to certain businesses put in a “trustee” relationship with the taxing jurisdiction.

“The rise of digital government and the deployment of excise taxes in places like the UAE and China is really setting the scene for the digitalization of tax collection,” says Dagley.

The growing enthusiasm for using taxes to shape behavior also has broader ramifications for businesses. Excise tax policies have long influenced the development of automotive products, transport networks, retailing and alcoholic beverages, but mainly at the margins. But now they are extending their influence to ever more sectors.

Traditionally, excise taxes were successful because they were levied on goods like salt and tobacco for which demand was inelastic. Now they are being recast as heavyweight tools to curb consumption and change behavior. For example, excise taxes on sugary drinks to address obesity or taxes on cars that run on fossil fuels to encourage the adoption of more environmentally-friendly electronic vehicles.

These new excise taxes are affecting consumer behavior and also have financial implications for businesses. Going forward, excise taxes could end up changing business models and playing a bigger role in corporate strategy.

Key action points

- Monitor closely excise tax developments in sectors and jurisdictions in which you operate.
- Review the extent to which excise taxes are taken into account in business models and strategic corporate decisions.
- Consider the external impacts of your goods or services. Could they trigger concerns from policymakers?
- Evaluate the effect of technology on excise tax collection. Can automation and digitalization provide more insight into your excise tax burden?

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Electronic cigarettes: blurred lines

It used to all be so simple. Cigarettes and other tobacco-related products were taxed. But electronic nicotine devices have got policymakers scratching their heads. Should they also be taxed like cigarettes? Eight US states have decided they should. Some European countries agree. But many other jurisdictions are waiting for further evidence about consumer behavior and health impacts before making a move.

Historically, governments taxed tobacco because it was a luxury, and with relatively few cigarette makers and importers – at least in western countries – it was an easy tax to collect. Since science proved tobacco smoke, some do contain nicotine, which is toxic and addictive. Recent studies have found that e-cigarettes containing nicotine could be linked with a greater risk of heart attacks and strokes, and harm the lungs of users.

As governments address e-cigarettes’ health-related questions, they must also determine if a tax is appropriate for such items, at what level, and how should it be calculated?

So far, governments have taken different approaches. In the US, some states based their e-cigarette taxes on wholesale price, while others based the law on milliliters of consumable product.

In Europe, several European Union (EU) members have so far opted to tax e-cigarettes or the liquid contained in them, including Portugal and Italy. In this niche industry, tax uncertainty will remain high for some years to come.

“The Immediate Submission of Information (ISI) program … will undoubtedly allow us to provide better service to businesses as well as reinforce control actions.”

Rufino de la Rosa
Director, The Department of Tax Management, Spain
The tax that conquered the world

Value-added tax is continuing to evolve and expand as new systems roll out and existing ones adapt to digital disruption and other forces.

By Gerri Chanel

In the six decades since the value-added tax (VAT) first made its debut in France, this broad-based consumption tax has spread rapidly across the globe.

Governments are fond of VAT and its cousin, the goods and services tax (GST), for many reasons. The levies are considered one of the least harmful taxes for economic growth and can raise large amounts of revenue because they apply to a significant proportion of economic activity.

According to the Organisation for Economic Co-operation and Development (OECD), some 166 countries operated VAT or GST in 2016 – twice as many as only 25 years ago. Many countries have had a VAT or GST system for decades. Other jurisdictions are recent adopters, such as Malaysia and Tanzania (2015), Egypt (2016), India (2017) and Member States of the Middle East’s Gulf Cooperation Council (2018).

Today, VAT and GST continue to expand and evolve as new systems roll out and existing ones adapt to the implications of digital disruption and other forces. This transformation has consequences for businesses, which must adequately prepare for new VAT and GST rules and procedures, and update their technology to comply with new e-filing requirements.

Early bird
Countries planning to introduce a new VAT or GST system should keep in mind that a well-planned transition is important. The introduction of such a tax requires adequate administrative capacity, training and technology on the part of both businesses and the government.

“There’s typically a broad public education program, as well as a lot of publicity about the resources that will be attached to enforcing the tax,” says Alan Schenk, Distinguished Professor at Wayne State University Law School in Detroit, who drafted VAT legislations for numerous Caribbean and African countries.

Royal Malaysian Customs Department Director General Dato’ Sri Subromaniam Tholasy says that it’s critical for businesses to start preparing for new VAT and GST systems far in advance.

“One of the biggest issues we had was businesses that did not prepare early enough in terms of systems testing and training,” Subromaniam Tholasy says. “Some companies left the implementation to the finance and accounting staff, but it requires much broader involvement. People from the sales and marketing sides also need to be involved since, for example, agreements may need to be renegotiated. It was also our experience that many small- and medium-sized businesses waited until the last minute, then had issues when it came to filing.”

Lessons learned
The design of VAT and GST systems should be broad-based and take a long-term rather than short-term view to be effective. Many jurisdictions have learned the hard way that if their initial VAT and GST system exempted too many items or entire economic sectors, it is hard to eliminate those exemptions later.

The task is made even more difficult when multiple jurisdictions require consensus to alter what is subject to tax, as is the case with the European Union (EU).
Key action points

- Ensure that people, processes and systems are ready for digitalized and comprehensive near real-time VAT-related reporting.
- Monitor the development of anticipated changes to VAT treatment of cross-border transactions, especially in the area of digital services.
- Develop active communication and engagement between policymakers and taxpayers about the potential impact of VAT policy changes so that new policies are clear and consistent, and that policymakers understand the business implications of any changes.

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“Indirect taxes are a collection of taxpayer data to the process of audits and inspections. Most tax authorities now require electronic filing of periodic VAT and GST returns and increasing numbers of tax authorities allow or require the use of e-invoicing for VAT and GST accounting.

This is a useful tool for businesses, as e-invoices generally cost significantly less to produce and process than printed documents. E-invoices can also provide a useful source of data for tax administrations and a more transparent audit trail.

In 2015, Sweden and other EU Member States introduced a new program for the reporting and payment of VAT, called the VAT Mini One Stop Shop (VAT MOSS). The VAT MOSS regime is a program that has provided administrative relief from the compliance burden. It allows suppliers to register online, file VAT returns and pay the VAT to a single Member State. This is one of the first tax systems in Sweden in which officers are working in a fully digital environment using email as the only method of communication, says Netterström.

In increasing numbers of countries, such as Brazil and China, taxpayers now submit detailed transactional information directly to the tax administration. Tax authorities are also beginning to demand the transmission of information on a real-time or near real-time basis.

Spain’s pioneering near-real-time reporting regime came into effect in July 2017. Rufino de la Rosa, Director of Spain’s Department of Tax Management, reports that the process is going well.

“The Immediate Submission of Information (ISI) program gives us immediate information on the companies’ invoicing, providing a control system for the actual development of the transactions performed, which in turn will undoubtedly allow us to provide better service to businesses as well as reinforce control actions,” de la Rosa explains.

De la Rosa says that despite initial concerns, all business sectors have shown a commitment to comply with the new rules, although some entities had some difficulty, such as nonestablished operators or international groups, in which decision-making takes place at the group level.

Even in these cases, however, “companies have been able to meet the

“In the EU, making changes is particularly difficult because all the countries need to agree unanimously on the change.”

Christopher Heady

Professor of Economics, University of Kent
requirements and count on the support provided by the tax agency, both to clear any implementing doubts and facilitate the supply of information,” de la Rosa says. Going forward, de la Rosa says that the next milestone is allowing businesses to know what their customers and suppliers have reported about their operations. “And in 2018, as a preliminary step to the eventual preparation of a draft VAT return, we are designing a taxpayer-friendly environment that will allow companies to see, in an aggregated manner, the information in the VAT register book that was submitted to the ISI.”

Digital threats
While digitalization is giving tax authorities faster and better information, it is also creating new challenges in the area of VAT and GST.

For example, the gross turnover that a large business generates using its employees is subject to VAT. But in the so-called gig economy, many of the newly self-employed may have such low turnover that they will not meet the VAT threshold in most countries. This, in turn, causes revenue loss to governments, according to Heady.

Cross-border trade is another challenge, especially when it comes to services. The rapid increase in digital services provided directly to consumers – from telecommunications to cloud services to online subscriptions – is challenging the fundamentals of how and where VAT and GST applies. Since nonresidents generally fall outside a jurisdiction’s VAT and GST tax system and it is difficult to collect the tax from final consumers, many countries now view these new services as a significant threat to indirect tax revenues and domestic service providers.

The OECD’s Task Force on the Digital Economy has been examining this issue of VAT and GST neutrality in the digital era.

Moreover, the OECD’s Committee on Fiscal Affairs and its Working Party No. 9 on Consumption Taxes are working on the implementation of the guidelines for VAT and GST neutrality.

“It is extremely important to ensure tax neutrality,” says Subromaniam Tholasy. “Otherwise, you are going to penalize local services.”

Malaysia and other governments are already taking or considering action to clarify and change their VAT and GST legislation for digital services. In October 2017, the Royal Malaysian Customs Department proposed amendments to the GST regulations that would address digital economy and e-commerce transactions. And, Subromaniam Tholasy says that the tax administration is having discussions with foreign suppliers about the best way to tax cross-border services.

There are more dramatic shifts in store for the VAT landscape in the coming years and businesses should prepare accordingly, predicts Gijsbert Bulk, EY Global Director of Indirect Tax.

“We believe that by embedding indirect tax issues early on in the planning process for a digital strategy, organizations can avoid unwanted surprises that could end up hurting their business and the bottom line,” Bulk says. “

“One of the biggest issues we had was businesses that did not prepare early enough in terms of systems testing and training.”

Dato’ Sri Subromaniam Tholasy
Director General,
Royal Malaysian Customs Department
Rebuilding borders

By Elliot Wilson

Businesses present in the UK and European Union (EU) – both local and global – face much uncertainty in the years ahead as the UK prepares to leave the EU. EY Tax Insights spoke with two businesses to learn how they are preparing for the unknown.

Best-case hopes and worst-case plans

When Alexandra Vale, Director of Value-Added Tax (VAT) Europe at Emerson, delivered a seminar to colleagues on the impact of Brexit, she was startled by the reaction.

“There were 40 finance and tax specialists in the room, but only two had thought about how it would affect us,” Vale says.

The pending departure of the UK from the European Union (EU) in 2019 is an event that the St. Louis-based industrial company can’t afford to ignore. Emerson is a major UK investor, with facilities in Manchester, Leicestershire and Scotland, as well as across the EU.

Many of the Emerson products are made-to-order and few finished items are kept in stock at a single location.

Purchasing is also performed on a procure-to-order basis to manage inventory. That kind of seamless production is leading practice – but it’s a system that only works when borders are open and trade flows freely across them. Brexit threatens that status quo.

For Emerson, it’s imperative to prepare for every eventuality, and to identify ways of ensuring goods continue to move smoothly across borders after Brexit. Vale points to the threat of goods held for inspection at borders, delaying arrival. Potential bottlenecks are everywhere, from London’s Heathrow Airport to ports like Dover in the UK, Hamburg in Germany and Dieppe in France.

“We need to know which border points are prepared, and also where serious queues could form,” Vale says.

While there are currently about 100 million imports/exports a year involving the UK border, the number of customs declarations could rise
by an additional 300 million post-Brexit, according to the UK’s Freight Transport Association. Vale says it is widely suspected that the infrastructure and officers currently in place at border sites will not be sufficient to deal with a hard border.

“There is very little time for this to be fixed,” says Vale. “So it is essential to understand the routes our goods take today to determine where our issues could arise.”

Back to the basics
It’s a learning experience for everyone at Emerson, not just in the UK but across Europe. Because trade flows two ways, Brexit will have consequences on both sides of the UK/EU border. While many worry about new paperwork and procedures for goods crossing into the UK after 2019, Vale says her continental colleagues have thought less about Brexit than those in the UK.

“We realize how much has to be done, and how far there is to go.”

Alexandra Vale,
Director of Value-Added Tax (VAT)
Europe, Emerson

For example, Vale says, German border authorities still have to recruit border guards and training them may take at least two years.

“We do not want goods being stopped at borders, but there is a high likelihood this will happen at the European ports as well as in the UK,” says Vale.

Vale says the business is tackling the most pressing issues by going back to the basics. “We are mapping our European trade flows to see where our goods come from and go to,” she says. This “stress testing” helps Emerson visualize both the trade routes and also to try and assess what levels of duty they would pay at the UK/EU border on various products.

Scenarios tested include an outcome where the two sides part company without reaching a trade deal similar to a free-trade agreement, which would mean that all businesses would be required to trade using World Trade Organization (WTO) duty rules and rates. “While we need to be able to assess probable border duties, we also need to consider what the additional clearance and handling costs will be – anything between £15 and £65 per transaction – and the additional headcount we would need to hire to process new borders transactions,” Vale adds.

Emerson also keeps all of its partners up-to-date on developments. Vale says she believes this is vital. “We need to review all our contracts and trading terms with every supplier and customer,” Vale says.
"If we have a customer in the UK today that we would deliver products to from our French manufacturing facility, would the customer be happy to deal with duty payments and paperwork, or would they expect us to do this? Our contracts need to be updated to reflect this and we need to have those conversations before Brexit hits so there are no surprises for either our suppliers or customers which could not only delay goods moving but also invoicing, etc.”

Long road ahead
One of the big unknowns is how the UK’s HM Revenue & Customs (HMRC) will tax imports from the EU. HMRC currently charges import VAT on goods as they enter the country from non-EU states, Vale notes. Key questions are whether firms will in future have to self-assess their taxes as their goods cross into the UK or whether there will be a major cash flow impact as the VAT needs to be paid up front. If a self-assessment regime is brought in will that mean additional reporting similar to Intrastat? How will duty be assessed under a self-assessment regime?

There are reasons to be hopeful. Compared to Italy, for example, Vale says the UK operates a highly simplified VAT reporting system, which will benefit companies of all sizes. And while Brexit will undoubtedly lead to border delays at first, she believes things will calm down after a year or two.

“It’s easy to forget that Europe had hard borders until the early 1990s, and a lot of business got done then,” Vale says.

Businesses can apply to the European Commission for “Authorised Economic Operator” (AEO) status to preempt post-Brexit pain.

“While only a few of our divisions have it, it’s worth doing,” says Vale. “If you are AEO-approved, the chance of a shipment being digitally fast-tracked through customs is far higher, although the application process is lengthy.”

Perhaps the biggest threat facing corporates is a general lack of readiness, which is unsurprising considering the challenges preparing for an unknown eventuality. Emerson’s approach is to hope for the best but prepare for the worst, according to Vale. “People assume we will magically end up with lots of excellent trade deals,” she says. “We realize how much has to be done, and how far there is to go.”

“From our point of view though, we don’t actually see a “border” – we distribute according to need and where our factories are.”

Michael Collins
Chief Finance Officer and Deputy Chief Executive Officer, LacPatrick
Indirect taxes

To understand the new trade-related border problems created by Brexit, it’s worth talking to LacPatrick, a 122-year-old Ireland-based dairy giant. A merger in 2015 gave it scale, with sizeable operations on both sides of the island’s internal border.

LacPatrick collects 600 million liters of raw milk from 1,100 farmers and suppliers in Northern Ireland and the Republic of Ireland each year. That liquid base product is dried for export as baby formula, or made into cheese at a new £30 million plant in the Republic of Ireland.

LacPatrick’s milk products make “hundreds of border crossings a day, from north to south and south to north,” reckons LacPatrick’s Chief Finance Officer and Deputy Chief Executive Officer Michael Collins. “From our point of view though, we don’t actually see a “border” – we distribute according to need and where our factories are.”

That’s about to change. The internal border was once a flashpoint in British-Irish relations, with goods and people heading in both directions often stopped and inspected. After peace talks in the 1990s, the border opened, the guards left, and trade flowed without interruption.

Then came the UK’s vote to leave the European Union (EU), and the border issue has once again resurfaced. Only one physical border separates the EU from what will soon be its first former member state, and it’s here. That raises two related questions: will Northern Ireland and the Republic of Ireland have a “hard” or “soft” border after the UK leaves the EU in 2019; and how it will affect the two-way flow of goods and services.

**Border woes**
Collins says the big fear is the return of a “hard” border. “It’s the logistics that concern me, queues of our trucks filled with perishable milk stuck at customs.”

In an effort to mitigate delays and other headaches at the border, LacPatrick plans to sign up to a “trusted trader” status, on both sides of the border, having already registered in the UK with HM Revenue & Customs (HMRC). This allows for shipments by “Authorised Economic Operators” to clear customs faster.

LacPatrick’s business model may also have to be re-evaluated as tariffs change after Brexit. The EU protects dairy farmers by imposing tariffs as high as 50% on milk imports. After March 2019, LacPatrick will be both inside the EU, and outside the EU exporting into it.

There is also the human element to consider. “We have farms that straddle the border, and a plant at Monaghan that employs people living on both sides,” says Collins. “But it is hard to see how there is no new infrastructure on the border once the UK is outside the customs union.”

**Facing the unknown**
For now, Collins and the business are focused on staying busy and keeping abreast of any rule changes. “We engage with the UK Government and the EU, as well as EY and our suppliers and customers, to understand potential new legislation, and filing and declaration forms. We are upskilling our administrative skills.”

Communication is vital, he adds. LacPatrick participates in as many forums as possible on both sides of the border with its suppliers, which number over a thousand. The business also maps and scrutinizes its supply chain on a daily basis.
A key question is whether firms will in the future have to self-assess their taxes as their goods cross into the UK.

So much of what the firm faces remains unknown for now. “We discuss likely outcomes on a day-to-day basis,” says Collins. “On one side of the spectrum there is a trade deal amenable to everyone, resulting in “soft” borders. On the other is a “hard” Brexit, a “hard” border, and trading under World Trade Organization (WTO) rules.”

One future may see its operations grow farther apart, not closer together.

LacPatrick already acts as a separate legal entity on both sides of the border, and Brexit could result in it effectively becoming two entities focused on different export markets.

In this sense, Collins prefers to see Brexit as both a challenge and an opportunity. “We see huge possibilities opening up as the UK strikes free trade agreements with non-EU states,” including the US and China, and nations in the Middle East, West Africa, Southeast Asia, he says.

“LacPatrick is well positioned on both sides of the border, thanks to recent investments,” Collins says. “In our view, the best way to mitigate risk is to have the right assets in the right places.”

Details of the future trade relationship between the UK and European Union were unclear at the beginning of 2018. All information in this article was current as of the print deadline of January 16, 2018.

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The UK-EU border: gone today, here tomorrow?

While the future of the UK’s ties with the European Union (EU) is still very much uncertain, what is clear is that the movement of goods flowing to and from the continent will be affected.

Until March 2019, the UK will be a full member of the EU’s single customs union, the benefits of which include one trade and tariff policy with no customs duties between Member States. Experts say the coming year will be key in determining whether two-way EU-UK trade will be free of friction – or full of it.

Three outcomes are often touted: a specially designed UK:EU trade deal; a Swiss-style free trade agreement; and finally, no agreement at all, with both sides trading under World Trade Organization (WTO) rules.

A deal acceptable to both sides could result in smart technology and trained border guards ensuring friction-free trade post-Brexit. But a no-deal with trade ruled by WTO laws could mean “hard” borders, customs duties and the reintroduction of two-way tariffs.

At the border

For now, businesses can reduce stress by planning for each eventuality. Some companies produce literally thousands of products, so it’s key they know what customs forms are required. In order to do so, businesses must have up-to-date operating systems and make sure their products are “scrupulously classified,” according to Mats Persson, EY Head of International Policy and Trade. This includes a product’s origin: (if a UK firm ships a Chinese-made jacket into the EU, it will likely be hit with a higher tariff than previously).

Another preemptive move companies can take to prepare for the post-Brexit era is to sign up with HM Revenue & Customs (HMRC) for “trusted trader” status, which ushers shipments by “Authorised Economic Operators” faster through customs.

“If the UK Government considers you trustworthy, your goods will likely be fast-tracked at the border,” says Persson.

Supply chains

As for complex pan-European supply chains, perfected over decades, multinationals are left asking if they will be “broken” by Brexit, or mildlysprained. In the EY report published in March 2017, Brexit – Official withdrawal UK from EU: Indirect Tax/GLOBAL Trade Consequences, EY said that regardless of the outcome of trade negotiations, Brexit would have a “large financial impact” on the British portion of global supply chains.

Ireland, the sole land-based UK-EU border, is likely to be the front line for post-Brexit trade issues such as border delays or disrupted supply chains. Marc Bunch, EY Global Trade Leader UK and Ireland, predicts the emergence of more fully local supply chains, with goods produced and consumed entirely on one side of a renewed “hard” Irish border.

VAT

And what will happen to value-added tax (VAT)? Will VAT rates change as the UK Government showcases its ability to set more business-friendly rates? Firms should look for ways to mitigate the VAT and customs consequences of a “hard” Brexit, according to the EY report on Brexit from March.

Under a “hard-Brexit” scenario, traders will likely have to pay VAT at a border, be it the Port of Dover or Heathrow Airport, and claim it back later. That would be manageable for bigger businesses accustomed to dealing with tax and trade complexities but likely painful for smaller firms, according to Persson.

The countdown to March 2019

In January, one betting company was offering 2/1 odds that a no Brexit deal would be reached by April 1, 2019, and 5/1 odds that another EU referendum would be held before that date. Businesses that have already started preparing for an uncertain future post-Brexit will be further ahead and more capable of responding to these changes than those firms that opt to wait and see what Brexit brings.
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Missing money

It was supposed to be easy. Yet obtaining general VAT/GST tax refunds can be an expensive and timely process for many businesses.
“Taxpayers – large and small – face complexities, delays, added costs and in many instances are completely unable to recover what they are legitimately owed.”

Joachim Englisch
Professor in Tax Law, University of Münster

By Bill Millar

The growing popularity of consumption-based value-added taxes (VAT) and goods and services taxes (GST) in the past half-century have turned businesses around the world into tax collectors. For tax authorities, it’s a great idea in principle. Relative to income taxation, the generation of more consumption-based taxes enables governments to obtain increased certainty and speed in tax collection. And for the most part, businesses remit what is due on their transactions, absorbing the administrative cost in the process.

Getting refunds is a different story. From overpayments to claiming credits for VAT collected by others, “taxpayers – large and small – face complexities, delays, added costs and in many instances are completely unable to recover what they are legitimately owed,” says Joachim Englisch, a Professor in Tax Law at the University of Münster in Germany.

For years, many businesses tolerated the situation, figuring the inability to cover refunds to be a cost of doing business and not worth fussing over. Increasingly, however, businesses enabled by technology and better processes are taking steps to get a clearer picture of the actual costs in terms of delays and losses, and are more aggressively pursuing what they’re owed.

A difficult process
In theory, getting a refund is simple, as in this hypothetical example: Take a VAT set at 10%. A cooper assembles a wooden barrel and sells it to a maker of fortified wine for $500. The winemaker pays the cooper $500 plus the $50 in VAT; the cooper collects and sends the VAT directly to the government. So far so good.

The winemaker lets the wine ferment and age in the barrel, then exports the barrel to a wholesaler for $1,000. The winemaker does not charge VAT on the transaction, because it is an export, and files a refund with the tax authorities for the $50 in VAT it paid to the cooper for the barrel.

And there’s the stumbling block. Because governments are wary of fraud, actually receiving the refund requires navigating complex compliance rules, enduring frequent delays and lengthy review processes, and suffering disallowances. These challenges grow exponentially for businesses operating on a global scale.

“Though insisting on immediate payment of VAT collections denoted by any invoice or return, most host governments in turn throw up all sorts of documentary and process requirements before credits or refunds are verified and granted,” says London-based Kevin MacAuley, EY EMEIA Indirect Tax Leader.

Refunds and credits are particularly challenging for taxpayers lacking a physical presence in the jurisdiction issuing them. For one thing, nonresident businesses have little influence over local policy regarding taxation. In fact, many countries make few if any provisions for such entities to obtain VAT/GST refunds. The EY Managing indirect tax refunds report, for example, shows that only 38 of 122 jurisdictions reviewed offer direct VAT/GST refunds to nonresidents.

“Even where available, such companies tend to encounter onerous application and review processes,” says MacAuley.

The root causes
So how could something so simple in concept evolve into something so burdensome and complex? Washington, D.C.-based Michael Keen, Deputy Director of the Fiscal Affairs Department at the International Monetary Fund (IMF), believes the primary cause can be found in the various issues that tax administrations repeatedly face in collecting the right amount of tax revenue from businesses.
Indirect taxes

Jurisdictions that refund VAT/GST to nonresidents

- Direct refund for nonresidents
- No direct refunds for nonresidents
- Gulf Cooperation Council — to be determined
- No refunds for nonresidents

“Complex compliance requirements are a common but not always wise reaction by tax authorities to what they fear are rampant abuses.”

Michael Keen
Deputy Director of the Fiscal Affairs Department, International Monetary Fund

“Complex compliance requirements are a common but not always wise reaction by tax authorities to what they fear are rampant abuses,” says Keen. “VAT/GST systems have encountered significant instances of fraud over the years — and tax administrations recognize they are still susceptible today.”

Among the simplest means of VAT/GST evasion, and likely the largest contributor to reduced VAT collections worldwide, is the underreporting of sales and therefore underpayment of VAT/GST, says Keen. However, there are many other means for cheating in VAT/GST. For example, forging of invoices claiming taxes paid can be a real problem.

Then there is “missing trader fraud,” a criminal practice in which a business ships goods into a country (VAT-free) and then sells the goods to other organizations (charging the customers VAT but not paying it to the government) before disappearing. Using buffer operations and other tools to manipulate flaws in the system, this type of fraud can generate VAT refund documentation and payouts where no VAT was ever paid in the first place.

Such goods are often shipped out of the country, then returned for one, two, three or even many more rounds of such false VAT refunds.

“Governments often find themselves placing onerous conditions on others simply because they’re concerned by their own inability to adequately manage VAT/GST processes,” Keen says.

Making matters worse

Nevertheless, taxpayers can be their own worst enemy in terms of making matters worse, according to MacAuley. Consider consolidated invoicing and billing, a move aimed at increasing efficiency. Customs data, payments for specific services and other documentation needed as evidence for refunds and credits often get truncated if businesses carry out such improvements without...
case, “if the operation is in a high-risk market, delays or denials could potentially kill their entire business.”

**Impact of automation**
Complex processes and rules are often an ideal candidate for automation, and this includes the digitalization of tax administration around the world. This will have consequences for VAT/GST compliance.

“Tax authorities are capturing the details of purchase orders, invoices, payments and the like – if not in real time, then something close to it,” says Tracey Kuuskoski, EY Leader APAC Digital Indirect Taxes, who is based in Singapore. “They will have a clear window into VAT/GST collections, payments and refunds.”

While higher degrees of automation would be a win for taxpayers, lowering their VAT/GST compliance costs and streamlining the VAT refund process, in many cases refund benefits will be slow to arise, according to Kuuskoski. That’s because many of the countries that are moving most rapidly from archaic to fully automated systems are emerging markets. Such nations will tend to have priorities other than paying VAT/GST claims, says Kuuskoski.

For example, in many cases, jurisdictions have been unable to resist holding on to such revenue, according to Keen. Closely related, he says many jurisdictions “are still developing the resources, skills and structures needed for their budget systems to properly manage VAT refunds.”

“Rather than set aside a portion of VAT/GST collections for eventual refunds, the risk is that the money gets spent as it rolls in,” Keen says.

For now, rather than use newfound automation to accelerate and streamline VAT/GST claims, these nations will instead use all the new data they have at their fingertips to look for ever more sophisticated ways to initiate new reasons for audits, says Kuuskoski.

“Delays will continue – at least until we reach some kind of new equilibrium,” says Kuuskoski.

Keen notes there will never be an era of perfect compliance and the elimination of fraud. Even greater automation is no cure-all.

“There are loads of creative people out there looking for the next chink in the armor,” says Keen. No matter how much technology is in use, there will be new weaknesses, and they will be exploited.

But progress is being made. Keen says that the IMF and others are doing their best to help national tax authorities the world over improve their budgeting and planning processes and show how that makes them more attractive centers for business, improving their economies. This in turn will lead such countries to be more open, fair and fast in dealing with VAT/GST credits and refunds.

“Hopefully it’s a compelling enough argument,” says Keen.
Consumption taxes have become part of everyday life. Unlike personal income tax returns, which command our attention at least once a year, consumption taxes get paid regularly. But what is taxed and by how much can differ widely from country to country, depending on the view of the government and tax administration.
Indirect taxes

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<th>GDP growth</th>
<th>Tax revenue as a % of GDP (2014)</th>
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- Taxes on income and profits
- Social security contributions
- Taxes on property
- Taxes on goods and services
- Other taxes


Credit: Christopher Jue
India

Introduction of goods and services tax (GST) to replace different state and central taxes.

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<th>Year</th>
<th>GDP Growth</th>
<th>Household Final Consumption Expenditure (% of GDP)</th>
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<tbody>
<tr>
<td>1980</td>
<td>71.9%</td>
<td>3%</td>
</tr>
<tr>
<td>2016</td>
<td>59.4%</td>
<td>12%</td>
</tr>
</tbody>
</table>

3%—12% GST
Indirect taxes

Tax revenue as a % of GDP (2014)

- India
- OECD

- Taxes on income
- Social security contributions
- Taxes on property
- Taxes on goods and services
- Other taxes

7.1% 2016

Credit: Ritam Banerjee
Germany

1968
Introduction of valued-added tax

Household final consumption expenditure (% of GDP)
- 1980: 56.9%
- 2016: 53.3%

GDP growth
- 1980: 1.4%

7%
VAT reduced rate
Indirect taxes

1.9%
2016

Taxes on income and profits
Social security contributions
Taxes on property
Taxes on goods and services
Other taxes


Credit: Jonas Friedrich
Indirect taxes

Navigating Brexit
Preparing for Brexit is not just a British challenge.

The departure of the UK from the European Union will also affect global businesses, with the potential to disrupt exports, supply chains and research and development functions.

There is just over a year to go until March 2019, when the UK formally exits the European Union (EU). A “hard” border may be established that would separate the UK from the European single market. UK companies and foreign subsidiaries located there are readying themselves for a major change.

But this isn’t just a focus for Britain – global businesses trading with UK-EU partners will also be affected. Given the strong trade links between the UK and the EU, the likely change in this relationship will have fundamental impacts on European businesses.

The UK is one of the top-three export markets for 10 EU members, including Denmark, Germany, Ireland, Italy, Netherlands, Spain and Sweden, according to Brexit – the Voices of European Business, a 2017 report from the Council of British Chambers of Commerce in Europe and Hogan Lovells.

The challenge will be to be able to make trade with the UK as easy as possible, as well as look at other markets that may become relatively more competitive. That’s because Brexit-related changes could alter existing business models, with possible disruptions to supply chains, longer lines at the border, additional required documentation and higher customs duties.

While some may have held out hopes for a Brexit reversal, recent developments indicate the UK withdrawal will proceed as planned and businesses on both sides of the English Channel are preparing for change. Brexit implementation took a big step forward in early December with the UK-EU announcement that the two sides had reached a deal in which the UK will pay the EU between €40billion to €60billion. That clears the path for talks on trade terms between the two entities.

“Brexit is becoming more real to people and businesses in Europe, and they are finally starting to think about what they should do,” says Walter de Wit, a senior member of EY’s Global Trade practice.

Tomorrow’s questions

Many organizations view Brexit primarily as a tax matter – a question of how much duty they’ll pay to access the UK market or import UK goods. Both the UK and EU want to sign a free trade agreement that could set tariffs lower than the maximum rates set by the World Trade Organization or eliminate them all together, according to Marc Bunch, EY Global Trade Leader UK and Ireland. (The UK and EU currently have no tariffs on imports between the two jurisdictions.)

Some European industries that are heavily reliant on UK manufacturing, including the auto, aerospace, engineering and life sciences industries, could face additional tariffs post-Brexit, according to the report Brexit – the Voices of European Business. That’s because the EU currently levies tariffs on goods and parts in which a significant component is produced outside the single market, and in the future, this could also include products that are partly manufactured in the UK.

While businesses can and should lobby officials to make clear what they would like to see in any future free trade deal, there are other questions to understand and address today. >
Indirect taxes

It is these issues that will ultimately determine tax outcomes and ensure businesses can still use their existing operations.

“The duty you’re going to pay is tomorrow’s question,” says Bunch. “There are more important questions for today, like whether you are going to be able to get goods in and out of the country come March 2019. The UK border is not going to be ready for this.”

In the pharmaceutical sector, for example, the future challenges aren’t with duties – the EU has zero most-favored nation tariffs for pharmaceutical products, according to a 2017 report from Bruegel. However, there are other non-tariff barriers that could affect the pharmaceutical industry, Bruegel noted. New types of compliance requirements and delays at the UK-EU border could make pharmaceutical products more expensive for UK residents and lead to lower trade, according to the Bruegel report.

In addition, European organizations with research and development (R&D) functions that are based in the UK could be affected by any changes to intellectual property protection arrangements between the EU and UK, according to Bruegel.

The coming negotiations between the UK and the EU on the free movement of people between the two jurisdictions also has ramifications for any European businesses conducting R&D in the UK.

“European companies have put a lot of critical research centers in the UK, and it’s going to be very important that they still have the ability to hire and retain talent,” says Paris-based Marc Lhermitte, who heads EY International Location Advisory Services for the European region.

“Highly skilled personnel need to have the mobility to move in or out.”

European businesses across all industries will need to work across many departments to handle the change. A new UK customs system is currently in development to clear goods, and that means new types of forms to fill out and new systems for the classification of goods. As a consequence, the data required from organizations will change, and businesses will likely need nearly a year to ensure the compliance of their information technology systems, Bunch said.

“Brexit is mostly perceived as a tax problem for tax people,” says Jeroen Blij, an Executive Director in EY’s Indirect Tax Team. “But when I talk to Chief Financial Officers, they realize what’s going to happen to their trucks at the border.”

Companies will need to consider how they would operate in and after the implementation period, particularly if the UK was to revert back to trading on World Trade Organisation terms. This would include testing their supply chains for relevance and efficiency. In particular, they should consider what might be offered by the EU or the UK to address the cash flow impact of cross-border movements giving rise to VAT upon import. It will be important to understand and agree with UK suppliers and buyers which party handles the border-crossing process, and to consider whether new UK licenses are needed to supplement existing licenses that span the EU.

Some of these changes will be merely logistical – altering stock-keeping unit (SKU) numbers to fit new classification systems, for example – whereas others will require lengthy negotiations with outsiders and the implementation of new IT systems.

“The challenge with Brexit is that the more you start thinking about it, the more issues you find that come up,” de Wit says.

At the very least, the agreement reached in December means the two sides can move on to the issues that matter for businesses, according to a statement released in December from Adam Marshall, Director General of the British Chambers of Commerce.
“It is imperative to keep up the momentum, as it’s high time to answer the huge practical questions on regulation, customs, standards, tariffs and taxes that lie at the heart of what businesses need to know in order to plan for the future,” Marshall said.

Untested system
The common thread is to prepare to deal with an untested system. The current volume of customs entries processed through the UK is 55 million annually, and that’s expected to surge to 255 million as more traders will have to go through the customs process, according to HM Revenue & Customs.

A new customs system – already in development in the UK before Brexit – is scheduled to be implemented in the months leading up to March 2019. But it was designed to handle 60 million goods clearances annually – roughly a quarter of future expected demand.

“I’ve no doubt that in ten years the UK can have a frictionless border for trade, but not within two years,” Bunch says.

Checks on truck loads originating from outside the EU at the Port of Dover currently take 45 minutes, according to a report from the Oxera economic consultancy. This figure could rise further if additional checks are required in the future. Subcontracting these tasks by hiring customs brokers won’t be an option for all EU organizations looking to move goods either, as that industry is also geared to handle roughly 55 million movements a year. The UK government, customs brokers and businesses will all be adjusting to the looming human resources challenge.

“German companies with a presence in Britain and Northern Ireland must now make provisions for the serious case of a very hard exit,” said Joachim Lang, Managing Director of the Federation of German Industries, speaking at a conference in Berlin in October 2017. “Anything else would be naïve.” Lang cited the auto, logistics, energy, finance and insurance industries as the most heavily exposed to any Brexit changes.

Supply chains involving the Republic of Ireland could see the biggest changes. Goods for sale in Ireland are commonly routed through the UK right now. After Brexit, however, if customs checks

All Brexit scenarios involve some form of UK-EU customs border implications, creating supply chain issues that may lead to additional costs and uncertainty. Whatever the outcome of current negotiations, businesses must prepare to navigate the changes ahead.

Six considerations for businesses affected by border changes:
- Moving goods in and out of the UK
- Impact on working capital
- Sourcing locations
- Validity of existing contracts
- Operating model suitability
- Immediate customs and border issues

Organizations should begin by reviewing their supply chains and taking pre-emptive actions. For example, applying for Authorised Economic Operator (AEO) status.

Sources: Brexit: Keeping your goods moving, EY, 2017.
“German companies with a presence in Britain and Northern Ireland must now make provisions for the serious case of a very hard exit.”

Joachim Lang
Managing Director, Federation of German Industries

were performed on all trucks passing through the Dublin Port between 5:30 a.m. and 7:30 a.m. each day, the lineup would stretch for nine kilometers, according to the report Brexit – the Voices of European Business. A plan by Dublin Port authorities to expand capacity won’t be ready in time for the change.

Be prepared
Despite the challenges and uncertainty, business will continue between the EU and UK and businesses on both sides of the new border need to plan now for the change. One option to supply the UK market would be to boost warehousing capacity in that jurisdiction and send fewer shipments, Bijl said. But waiting too long could mean paying a premium, as the UK is already short of retail warehouse space. Vacancy rates in mid-2017 had sunk to a historic low of 5.3%, thanks in part to the growth in online retailing in recent years, leading to those types of businesses occupying existing warehouse stock.

Another potential solution to cut down the time for customs clearance is to become an Authorized Economic Operator (AEO). This is a status attainable from the EU for any business involved in a cross-border supply chain, and allows for minimal checks to loads crossing in either direction. Both the UK and EU have said they will deal with the initial transition in the months following March 2019 by waving through shipments from organizations with AEO status, Bijl said.

Avoiding border disruptions means reforms beyond the supply chain as well. Contracts between UK and European businesses will now need to spell out which party is responsible for customs clearance. Typically, this would mean inserting clarifying language according to commercial terms defined by the International Chamber of Commerce, according to de Wit. It would likely make sense for the UK party to the sale to handle imports into that country rather than having European companies establish tax and VAT numbers. For some industries, the volume of contracts means they should get started now: “I’ve got some clients with 20,000 contracts,” Bunch said.

Those businesses operating in highly regulated sectors also face a laborious process to ensure paperwork is in order post-Brexit. Pharmaceutical products, for example, may need a new set of licenses to be sold if they are coming from the UK into the EU.

“You need scientists who are held responsible for the quality of the drug working in the country in which a license is held,” Bunch says. “Getting a new license is a 15-month journey. It’s a bureaucratic process.”

Once a European business addresses these issues, attention can then turn to other beyond-tariffs concerns such as cash flow, Bijl says. As of March 2019, businesses moving goods between the EU and UK are likely to need to make VAT payments and file for refunds, which could come on a quarterly or monthly basis and leave companies with receivables to account for. Some countries allow deferred payments, including Belgium, Finland and
Contracts

Are your contracts still fit for purpose? Many EU-UK contracts did not envisage Brexit and are silent on such things as Incoterms. What terms do you want post-Brexit? How many contracts need to change and how long will it take?

Regional supply chain operating models
Many organizations run regional supply chain structures within the EU that have specific tax attributes. The impact of Brexit on centralized supply chain and procurement hubs hosted in the UK will depend on how they are configured.

Basic physical supply chain questions need to be asked. Do I now need to consolidate? If so, where and which flows?

Suggested next steps

- Evaluate your supply chain
  Businesses need to understand the time sensitivity of their supply chain. Are there areas where delays will significantly impact the business?

- Perform data analytics and network optimization
  Businesses should look at where they can consolidate goods, how warehouses are sized, where they are located within Europe and whether relocation or revaluation of assets should be considered.

- Becoming an AEO
  AEO accreditation can enable businesses to benefit from faster customs clearances and gives assurance to HM Revenue & Customs that the business operates a secure and trustworthy import and/or export practice, allowing swifter approval of special procedures.
  Businesses are already recognizing the benefit of AEO, as illustrated by the spike in applications in the chart below. Further promotion of the AEO regime, its benefits and assurances that will continue after Brexit, will ease transitional tension in trade.

Key action points

- Preparing for Brexit means understanding what changes need to be initiated as soon as possible, such as updating IT systems to cope with new paperwork demands, or acquiring new licenses for products sold between the UK and EU.

- Supply chain reviews could help spot newer and more efficient routes to market, and eliminate ones that could become more costly or slower after Brexit.

- Cash flow factors to consider in the post-Brexit era include concerns such as VAT refunds.

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the Netherlands, and businesses may find it worthwhile to route goods through these destinations instead of preserving existing trade routes, Bijl says. The UK may also introduce this facility post-Brexit.

“These are things you can do and think about now, even though we don’t know the result of Brexit,” Bijl says. “The main response of European companies so far is that they’re not going to do anything until they know the outcome of Brexit, but it’s going to be very important to be prepared.”

Details of the future trade relationship between the UK and European Union were unclear at the beginning of 2018. All information in this article was current as of the print deadline of January 16, 2018.
Brave new world

By Karen Lynch

While governments aren’t typically the first movers in today’s digital economy, indirect taxation is proving to be an exception.
The stakes are high for businesses today as governments around the world use technology to accelerate the collection of trillions a year in value-added tax (VAT) and other consumption taxes. Taxes on both general and specific goods and services are big sources of revenue for governments. Over the years, VAT, sales, excise, customs and other consumption taxes have accounted, on average, for about 10% of gross domestic product (GDP) for the 35 countries in the Organisation for Economic Co-operation and Development (OECD). Businesses are charged with collecting most of the vast sums that are generated through transactions with consumers and corporate customers, and must then transfer them to tax administrations. While governments aren’t typically the first movers in today’s increasingly digital economy, indirect taxation is proving to be an exception, and businesses often have a hard time keeping up. Manual and semi-automated procedures for assessing, collecting and auditing consumption taxes are currently being overhauled by tax administrations worldwide – all of which vary somewhat in their timing and approach. Providing a glimpse of the future, some administrations are also venturing into innovations such as the blockchain distributed ledger technology. Today’s digital tax automation initiatives are not half-hearted. “Once these governments get going, they have the deep pockets to invest in automation and the power to realize their objectives,” says Gijsbert Bulk, EY Global Director of Indirect Tax, in Amsterdam.

**Out with the old, in with the new**

The goal is to collect more tax dollars, more quickly, and to make sure it’s the correct amount. In doing so, governments hope to close shortfalls such as the “VAT gap” between what they expect in taxes and what they actually collect (with the 2015 VAT gap estimated at 151.5 billion euros in the European Union alone).

The old practice of monthly or quarterly VAT filings is fading fast. There are several reasons for governments to digitalize indirect taxes first. For starters, consumption taxes generate a lot of money for governments, accounting on average for 31% of total tax revenue among OECD members. In general, indirect taxes are easier to assess than corporate taxes, despite complications like cross-border transactions, returns and exemptions. And, as the relatively straightforward product of multiplying transaction value times tax rate, they are more objective and less prone to controversy than direct income tax.

There is another fundamental driver, according to Channing Flynn, EY Global Digital Tax Leader in San Francisco. “In the global digital economy, governments are finding it increasingly hard to tax income,” he says. Tax authorities have seen certain technology businesses operating globally for years without making a (taxable) profit. More industries are digitalizing their business models, in areas such as FinTech and autotech, with hard-to-define tax profiles based on virtual global networks and intellectual property. “So policymakers are saying, let’s go for the low-hanging fruit of indirect tax,” says Flynn.

Among the earliest to automate, beginning a decade ago, have been governments considered most exposed to tax fraud, such as Brazil, Mexico and Russia. As these innovators began to report sharp increases in indirect tax revenue, more governments started stepping up. Meanwhile, such major jurisdictions as India and the Gulf Cooperation Council of six Middle Eastern states are now introducing VAT-type taxation for the first time, using systems that are highly automated from the start.

Usually, tax administrations’ new systems and procedures tend to evolve (though not always linearly) through five levels, as described in an EY framework. First come e-filing requirements for traditional tax returns and forms. The second level is e-accounting, with businesses required to digitally submit source data such as invoices – often in real time or close to it. E-matching then occurs, when administrations map data across tax types and, potentially, across buyers and sellers. E-audit is exactly what the name implies, digitally-enabled tax auditing – often with a limited window for businesses to respond. E-assessment is the ultimate step, in which tax payments are calculated automatically by the tax administration based on the data received from businesses.

## Development of Brazil’s Public Digital Bookkeeping System (SPED)

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>E-platform to register imports/exports</td>
</tr>
<tr>
<td>2005</td>
<td>e-CAC, Virtual taxpayer assistance center</td>
</tr>
<tr>
<td>2007</td>
<td>CT-e, Electronic transportation invoice</td>
</tr>
<tr>
<td>2009</td>
<td>ECD, Digital Accounting Bookkeeping</td>
</tr>
<tr>
<td>2010</td>
<td>FCONT, Phase 1: Transition Fiscal Accounting Control</td>
</tr>
<tr>
<td>2011</td>
<td>ECD FCONT, Phase 2</td>
</tr>
<tr>
<td>2013</td>
<td>SISCOSERV, Integrated Foreign Trade System for Services, Intangibles and Other Operations that Produce Changes in Equity</td>
</tr>
<tr>
<td>2014</td>
<td>ECF, Digital tax bookkeeping for corporate income tax</td>
</tr>
<tr>
<td>2015</td>
<td>Block K-VAT, Monthly inventory and production reports</td>
</tr>
<tr>
<td>2016</td>
<td>eSocial Labor, Reporting obligation to gather labor, social security and tax information concerning employees and independent contractors</td>
</tr>
</tbody>
</table>

**Source:** EY
Indirect taxes

administrations forgo tax filings altogether. Instead, they analyze the data businesses have transmitted, determine the tax rate and take the money out of corporate bank accounts, unless their findings are contested.

Some of the world’s largest economies, such as Japan, the UK and the US, still rank on the first level of this scale, according to Carolyn Bailey, EY Americas Digital Tax Administration Services Leader. Thirty-plus countries around the world are at level two, she says. Brazil, Mexico and Russia have reached level four. Many more administrations are likely to move from level 1–2 to level 4–5 within 5 to 10 years, with advances such as blockchain, says Bailey.

Troublesome transition
To date, however, the transition has proved difficult for businesses. One issue is timing. As governments speed their collection of tax information and cross-check that data between buyers and sellers, mismatches can occur – for example, if one side of a transaction books an invoice in May and the other books it in June.

“Siemens has more than 600 litigation cases in Brazil alone, and most are related to automated assessments,” says Christian Kaeser, Chairman of the Tax Commission of the International Chamber of Commerce (ICC) and Global Head of Tax at Siemens AG, in Munich. Other businesses are in the same situation in Brazil, says Kaeser, who expects to see similar patterns – to a greater or lesser extent – in other jurisdictions that automate their indirect tax systems. “There will always be cases where the timing will not match 100% in any given period,” says Kaeser. “And the shorter the period of time, the greater the chance of a timing mismatch.” When mismatches result in official notices from tax authorities, businesses find themselves having to explain and litigate over and over. “That is simply multiplying the workload for us,” he says.

Kaeser expects the situation to improve as, for example, tax administrations’ algorithms adapt. “Logically, the systems will get better, but don’t ask how long it will take,” he says.

Some businesses that have filed for refunds in Mexico have faced another challenge. Better equipped tax authorities have applied greater scrutiny, causing delays and tying up cash flow, according to Teresa Rodríguez, Indirect Tax Partner at Mancera, SC, an EY affiliate in Mexico City. Other issues include continual changes in tax rules and inconsistency from one jurisdiction to the next. There is even a lack of consistency in the way jurisdictions are implementing standards – for example, the OECD’s Standard Audit File – Tax (SAF-T) for the export of accounting records in a commonly readable format.

“They’re supposed to all follow one framework, but each one makes it just different enough to drive you nuts,” says Bailey, citing governments’ varying data requirements, scope and frequencies. Inconsistency doesn’t only add administrative costs, but it also increases the risk of errors and of double taxation, says Kaeser. These and other transitional issues are among the topics being addressed in a new working group of the ICC’s Commission on Taxation.

“The bigger your business, the more systems you have, the more procurement and accounts payable platforms, the more difficult the task of complying,” says Adrian Hextall, Director, Financial Services, Tax Technology & Transformation at EY UK, in London.

Getting businesses on board
For their part, tax authorities realize the challenges taxpayers face. “The tax administration in Mexico doesn’t expect 100% compliance right now from taxpayers because it’s a transitional period,” says Rodríguez. “But they expect taxpayers to accept and incorporate these changes, rather than fight them.”

Governments also point to the benefits businesses can ultimately realize. In Mexico, for example, the tax administration will
reward compliant businesses by reducing the standard time it takes for them to receive VAT refunds (from 4 to 6 months down to 5 days), says Rodríguez.

In Brazil, many regular information reporting requirements have been discontinued, says Altemir Linhares de Melo, Advisor to the Cabinet of the Federal Revenue of Brazil. “This means reducing the costs and time to comply with ancillary obligations, significantly improving the country’s business environment and, consequently, increasing the competitiveness of Brazilian companies,” says Linhares de Melo. Over time, technology should help tax administrations conduct shorter, more focused audits, says Rodríguez. There will be fewer “fishing expeditions;” she says, which should translate into efficiencies for both the tax authority and taxpayer.

**Technological tomorrow**

The speed of change could further accelerate, as governments continue to experiment with new technologies and share leading practices (as well as cross-border tax data) in such settings as the OECD’s Forum on Tax Administration (FTA). For example, the FTA’s series of publications on the “Tax Administration of the Future” advocates that “big data and blockchain approaches open the possibility of new ways of managing large VAT transactions involving refunds or cross-border transactions.”

Many businesses are upping their own technology game to meet the challenges posed by the digitalization of indirect taxation. Barbara Brogan, a Senior Manager in Pfizer Inc.’s Global Tax Department, recently described the pharmaceutical business’s pilot of robotic process automation for invoice retrieval related to US sales tax and European VAT. The pilot has demonstrated savings of hundreds of hours per year, providing the tax team with more time to devote to other value-added tasks, such as reviews.

“Hopefully it results in some tax rebates for us,” Brogan said on an EY webcast in June. There is also a less tangible benefit. “Who wouldn’t want to take advantage of a technology that has the ability to remove the mundane, manual tasks from your role?” she said.

Along the way to tomorrow’s technologies, tax departments are increasing their use of various tools, such as indirect tax dashboards for specific tasks, while tapping into the enterprise resource planning systems handling their business’s transactional data and upgrading to cloud-hosted environments for recording data across their global organizations. Advanced analytics, in turn, help businesses validate their tax data at a more granular level. This reduces risk as they move beyond sample-based testing to including all relevant data and then drilling down into the relatively few records that surface as anomalies.

But many are still stuck doing indirect tax the old way. “The internal workings around tax and VAT are very much back-office functions, and back-office functions are the ones that have never received much investment, because they’re not customer-facing,” says Hextall. “That whole infrastructure piece is going to need upgrading, and it’s going to cost a lot of money.”

For some businesses, internal organizational issues prevail. Usually, the tax team’s main source of information is the finance department, which has always prioritized sending earnings and other performance metrics to the board, financial regulators, exchanges and shareholders. “The idea of reporting your indirect taxes to the government faster than reporting your earnings to the financial market is a complete upheaval of what’s happened for 100 years,” says Flynn. “So you have to get your finance organization in line with these new rules.”

Those businesses that remain in the mode of spreadsheet reporting, manual reviews and informal compliance processes for indirect tax are increasingly vulnerable and inefficient, says Bulk. Those that have created processes where checks and tests have been automated, exceptions and errors are reported, and remediation tasks are managed – all without human intervention – are more in control and can detect and repair mistakes much more quickly.

Benefits extend beyond the tax department, as well. Mining and reporting all transactional data in a real-time environment can provide a lot of information to a business. For example, it can deliver a real-time view of how many products were sold in any particular market at any particular time or, with machine learning, begin to predict sales patterns to refine timing and pricing.

“The technology to administer indirect taxes is going to provide better insights thus enabling companies to more quickly decide important strategic tax items,” says Flynn.
Indirect tax gets philosophical

When should an item or service be taxed and by how much? This is a question that tax authorities deal with every day around the world – with very different outcomes.

By Gerri Chanel
When it comes to consumption taxes such as value-added tax (VAT) and goods and services tax (GST), the difference between an essential everyday item and one deemed a luxury reflects a society’s values as well as the quirkiness of human logic. Tax administrations must deal with such philosophical questions on a regular basis, determining tax status and tax rates for products that don’t fit neatly into one clear category. While tax bureaucrats try their best, their conclusions can lead to inconsistency and debate. The more distinctions, the harder it is for taxpayers and tax administrations to get it right. Reviewing the correct application of distinctions can be costly and result in disputes that can drag on for years. Errors can lead to consumers being overcharged or tax revenues being under-collected. Different tax treatments between similar products can distort competition (for example, if one snack is taxed at 15% while a similar product is taxed at zero, the maker of the taxed product has to charge more and risk losing customers or cut its margin and risk not making a profit).

When is a cake not a cake? Perhaps the greatest inconsistency is in the area of food – that most basic of human needs. But “basic” depends on where you are, what you’re eating and how you’re eating it.

First there’s the “where” to consider. Cooking oil, for example, has long been a target of taxation. It was taxed by the pharaohs of ancient Egypt and it’s still taxed today – depending on where you live. In July 2017, Malawi eliminated its 16.5% tax on edible oils while in 2015 Greece significantly raised its VAT rate (now 24%) on all cooking oils except for olive oil, a staple of Greek cuisine, which stayed at 13%.
Indirect taxes

“We are looking at whether the guidelines still reflect the very rapidly moving nature of salads.”

Australian tax official

Then there’s the question of “what” it is you’re eating. Defining a taxable food can be tricky. In the UK, cakes are exempt from VAT as are plain biscuits (cookies), but add a layer of chocolate to those biscuits and they’re subject to VAT. In 1991, a UK court considered the case of Jaffa Cake, a popular treat with a chocolate coating over a layer of sponge and jam. The business successfully argued that the sponge layer made it more like a cake, and that the product became hard like a cake when it was stale rather than soft like a biscuit.

If a cake is not always a cake, neither is a candy bar always a candy bar. In the US states of Illinois and Washington, chocolate bars are exempt if they contain flour.

Finally, there’s the “how” to contemplate; the place you consume your food can also affect its taxability. For example, in Switzerland, the VAT rate for food served in a restaurant is 7.7%, versus 2.5% if sold over the counter for takeaway.

Even the way the food is prepared can make a difference. In New York, a loaf of bread sliced in a bakery is exempt, but a sliced bagel is taxable. Buy it whole and it’s exempt.

Changes in food trends can lead to new challenges. Take Australia’s 2017 review of the taxation of fresh foods under the country’s GST. During parliamentary testimony, an Australian tax official explained that “We are looking at whether the guidelines still reflect the very rapidly moving nature of salads … because the market has shifted quite a lot.” He noted that “some people may define a salad as a bowl of lettuce; some may define it as a barbecue chicken shredded up with three grains of rice on it. I am not trying to be facetious, either; there are a range of products that are very, very different that are marketed as salads.” Officials subsequently decided to drop the review and retain the current tax status quo for salads.

Tax the embellishments

Jurisdictions may wrangle with how to tax basics like food, but they are more consistent with the idea of taxing luxuries and “sin,” though the definition of both is in the eye of the beholder.

Consider this editorial in an 1893 London political journal: “New fashions in dress — and more especially when those are adopted from the Continent — should be heavily taxed … Tax false hair, paint, powder, and all other such fictitious embellishments.”

We may have moved away from such fashions but the idea of taxing embellishments is still alive and well today, though sometimes without much consistency. Consider tattoos. In the US, some states exempt tattoos from sales tax as permanent makeup while others tax it as a beauty service. In Denmark, tattooing is generally subject to VAT, but may be exempt if enough freehand artistry and creativity is involved.

Sometimes items taxed as a luxury may not seem fair to consumers. According to India’s new GST system, which came into effect in July 2017, movie tickets are subject to the same top rate as casinos and top hotels (28%). This makes going to beloved Bollywood movies less affordable for the middle classes than it might otherwise be.

But taxpayers can get creative. When the Spanish VAT on theater admissions was raised to 21% in 2012, one Spanish theater owner found an original solution to maintain live theater ticket sales. Since vegetables are subject to a much lower rate, the theater began selling carrots instead of tickets; with a carrot purchase came free admission to a performance. The move led Spanish media to dub it the “Carrot Rebellion.”

A sweet tooth rebellion could be next. While many jurisdictions have long taxed “sin” items such as alcohol, tobacco and gambling, the modern definition of sin increasingly includes items such as junk food, sugary drinks and candy. Many governments are introducing sugar taxes on top of VAT/GST to try to address rising obesity rates by encouraging healthier lifestyles. But here too the lines are blurred. Some jurisdictions have chosen to levy taxes on sugary drinks but not certain fruit juice blends, candy or cakes.

The answer to why sugary drinks — but not certain treats — are bad for one’s health and therefore subject to higher taxes is among the philosophical riddles that tax administrations and consumers will be contemplating in the years to come.

Footnotes

1 “Massive VAT hike sends prices soaring for Greeks and tourists as banks finally reopen after three-week closure,” Daily Mail, July 20, 2015
2 “Cake or biscuit? Why Jaffa Cakes excite philosophers,” BBC, February 20, 2017
3 Illinois Department of Revenue; “Some candy bars aren’t ‘candy,’” Seattle Times, May 31, 2010
4 “Zum Mitnehmen oder zum Hierssen?,” Tages-Anzeiger, August 28, 2014
5 “Cutting that bagel will cost you: Weird state tax laws,” USA Today, March 31, 2013
6 Parliament of Australia
7 “Carrot or not carrot? But some said, ‘It’s a cake,’“ Daily Dead, July 20, 2015
8 Danish Customs and Tax Administration
Indirect taxes

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