Facilitating Better VAT Compliance

By Philip Robinson and Jeffrey Saviano

The balance of taxation around the world is shifting. With many governments in developed countries facing record budget deficits and high levels of unemployment, taxes on consumption are increasingly seen as playing an important role in the taxation mix. Already a number of countries have raised taxes on consumption, and it seems likely that more will follow a similar path over the next few years. Many economists believe that a greater focus on consumption taxes will help to stimulate growth because, unlike corporate income taxes, consumption taxes are viewed as having less of an impact on corporate profits and thus appear to have less of an impact on corporate investment decisions. As such, there is a strong possibility that the United States will consider a consumption tax as a means to reduce its heavy reliance on income taxes, both personal and corporate. Many economists believe the U.S. may wish to consider a VAT as a means to cut the federal deficit, while others believe a broad-based tax increase during a precarious recession rebound could stall recovery. One thing is certain: The debate will intensify during 2011.

Even if governments do not follow a policy of shifting the tax burden from income to consumption, taxes on goods and services will nevertheless play an important role in correcting the significant fiscal imbalances that have built up over the past few years. Consumption taxes are also vital to helping governments manage their cash flow effectively because they are collected throughout the calendar year, not just at year- or quarter-end.

Consumption taxes include a number of variations such as VAT, goods and services taxes, and sales and use taxes (SUT). For ease of reference, in this article we will refer to these taxes collectively as VAT. Most countries levy some form of VAT, and
while the rules may vary, the compliance issues are broadly similar and apply across jurisdictions and tax types.

The immediate concern for multinational enterprises is how this increased focus on VAT compliance and enforcement will affect their businesses. Given the large number of transactions that they conduct and the global nature of their operations, MNEs already face a highly complex and challenging VAT environment. As governments around the world impose more stringent requirements, increase enforcement efforts, and apply legislative changes to strengthen their fiscal position, businesses are likely to face increased burdens in the form of higher administrative costs and stiffer penalties for errors. Moreover, as VAT obligations and complexities multiply, full compliance becomes more difficult to achieve, which means the likelihood of making errors and incurring penalties is even greater.

In many respects, taxpayers and tax administrations share a common goal. Both want a system of taxation that enables multinational VAT compliance to be managed effectively and efficiently. For governments, a fair and efficient system means that incidences of fraud decrease, while a growth-friendly tax environment will help stimulate the economy. MNEs will benefit from a reduced compliance burden, a decrease in tax risk, and a lower incidence of fines and penalties. And for both, scarce resources can be directed toward more constructive activities.

In a recently published paper, “VAT and GST: Multiple Burdens for Multinational Companies,” Ernst & Young examines the changing environment for taxes on consumption. Based on research covering the VAT systems in 90 countries and interviews with corporate tax directors and tax administration officials around the world, the report provides comments and suggestions that could help to ease the compliance burden and build better relationships between taxpayers and tax administrations.

**The Business Burden**

From a governmental viewpoint, VAT is a highly cost-effective form of taxation because the collection process is carried out by the businesses that provide taxable goods and services. The cost of administration falls largely on businesses, which must adapt
their commercial processes to ensure the tax is collected according to the rate, method, and timing set out by each tax administration.

For many MNEs, this is a frustrating situation. VAT compliance is an additional cost over and above what the company would spend for its own commercial purposes. Companies must establish, operate, and constantly review accounting processes to administer a tax that, in theory, they do not actually pay themselves. In essence, MNEs have become the unpaid tax collectors of the VAT system. While businesses also pay VAT on their purchases and may recover some or all of that input VAT from the government, this recovery can occur only if the company complies with fairly stringent rules established by the relevant governments. Therefore, companies must embed these intricate VAT rules into their accounting systems and processes to ensure they can appropriately recover input VAT, as well as administer VAT collections.

At the same time, allowing businesses the opportunity to collect and retain large amounts of tax can leave the system open to fraud and manipulation by dishonest traders. To protect their tax bases, tax administrations must protect their consumption tax receipts against systematic VAT fraud.

Although MNEs aim for 100 percent compliance — which we might term as always paying the right amount of tax, at the right time, to the right tax administration — meeting that goal can prove extremely burdensome in terms of company resources. The cost of compliance includes expenses incurred in obtaining information; training staff; managing VAT audits, inquiries, and disputes; the cost of financial penalties (which are not generally deductible against profits for direct, corporate income tax purposes); and the cost of VAT related to legitimate business expenditures that are not recovered (that is, in foreign jurisdictions).

One of the biggest compliance challenges for MNEs is capturing the information needed to complete their VAT returns accurately within tight deadlines. The nature of VAT effectively requires taxpayers to account for every business transaction accurately in real time, because the tax treatment of each supply of goods or services is decided when the supply occurs and must
be reported and accounted for on the VAT return shortly after the transaction. This necessitates the effective use of technology and well-designed business processes to capture the relevant data and ensure that the complex VAT rules are correctly applied to the transaction. For MNE taxpayers, this is a daily task that applies to large numbers of transactions, and many jurisdictions impose penalties for individual invoices that aren’t issued on time or that contain errors.

Filing VAT returns is another task that requires accuracy within a limited time frame. In general, the shorter the VAT reporting period, the shorter the filing deadline. And with countries around the world often stipulating slightly different timing, the filing process can prove extremely challenging for large organizations with complex business activities but limited resources.

The Ernst & Young report indicates that the diversity of obligations that MNEs must deal with around the world makes it more difficult to achieve full compliance. Few companies do business today in the same way and in the same markets as they did 10 or even five years ago. Business models have evolved and are constantly evolving. VAT systems often struggle to keep pace with globalization, because in most countries, the basic legislation was adopted many years ago, before the advent of e-commerce and when fewer companies engaged in cross-border trade.

In short, the volume of transactions that require effective VAT management is increasing, whether across multiple jurisdictions or within the same family of companies, and each change in how or where an MNE does business will have far-reaching implications for its VAT compliance. As businesses evolve, they must constantly review their VAT reporting obligations, including the impact on their financial condition and working capital requirements.

Tax administrators expect full compliance with their own tax requirements regardless of other countries’ rules and practices, and there is little harmonization between countries even within trading blocs such as the European Union. That places an additional burden on companies, because they must adapt their
systems for multiple individual requirements that apply to essentially the same commercial processes.

Uncertainties over the specific requirements of tax systems within some jurisdictions add an additional layer of cost and complexity. For example, while VAT systems generally allow businesses to recover or deduct VAT paid on most legitimate business expenses, there are exceptions. Some countries may not refund VAT to nonresident businesses, may exclude some types of business expenses, or may have highly complex procedures for recovering charges. Also, there may be different rules that apply to some types of cross-border transactions, which means VAT may apply in more than one territory for the same transaction. In extreme cases, these uncertainties in the tax system can deter companies from making business investments or entering into strategic trading relationships.

Fast-changing VAT legislation, particularly at a time when governments are moving toward consumption taxes as a source of additional revenue, adds further complication. Keeping up to date with developments around the world is a full-time task and poses a major challenge for all global companies in meeting their real-time VAT reporting obligations. Legislative changes occur so quickly and frequently that companies need to allocate substantial resources to undertake a comprehensive review of all the possible effects to their global business. When changes do occur, the MNE must adjust its accounting processes quickly to ensure that it remains compliant and avoids penalties.

Besides shouldering the VAT collection obligation, businesses often must fund VAT payments in order to recover the tax from their customers. This factor, and the delays commonly experienced in receiving VAT credit refunds from tax administrations across multiple jurisdictions, can adversely affect cash flow.

Reducing the Burden

Given the compliance burdens imposed under a VAT system, it isn’t surprising that a survey of VAT professionals, directors, and officials produced a wish list of changes that would improve VAT compliance among MNEs. For the most part, these suggestions for change also are supported by the OECD’s taxation framework.
Neutrality

Business decisions should be motivated by economic rather than tax considerations. VAT compliance issues exert undue influence on those decisions. For example, factors related to VAT compliance, such as the desire to avoid foreign registrations or avoid incurring irrecoverable VAT, may deter a company from making a certain investment, or encourage activity that is less than optimal from a business standpoint. Changes such as the simplification of foreign VAT refunding procedures, the extension of arrangements for refunding VAT, and the harmonization of VAT rules for cross-border trade to avoid double taxation would be valuable steps toward creating a more neutral decision-making environment.

Efficiency

Both taxpayers and tax administrators would benefit from a more streamlined and consistent VAT compliance environment across borders. The complexity of the current system means many organizations are using shared services centers to meet their multinational VAT obligations. While that may increase operational efficiency, it can also expose the company to tax risk. Greater harmonization and standardization of rules and reporting obligations would improve efficiency, as would greater consistency of treatment among EU countries and longer filing deadlines to allow taxpayers to get it right the first time.

Certainty and Simplicity

Highly complex VAT rules are counterproductive, as they make it harder for taxpayers to meet their obligations accurately. VAT rules should be simpler to understand, so that taxpayers can anticipate the tax consequences in advance of a transaction and know when, where, and how to account for tax. Individual tax administrations should communicate with taxpayers more frequently and effectively and consult more widely before making legislative changes. When legislative changes are made, administrations should give taxpayers sufficient notice so they can implement the necessary systematic upgrades. Clearer, more straightforward legislation, along with appropriate advanced rulings, would provide greater certainty and help protect governmental tax revenue.
Effectiveness and Fairness

Both taxpayers and tax administrations want a system that is fair and effective. There should be a framework in place to collect the right amount of tax at the right time, while minimizing the potential for tax evasion. Scrutiny of individual taxpayers should be proportionate to the risks involved, so that companies are not excessively penalized for trying to be fully compliant. A closer relationship between business and tax administrations, based on open disclosure, can be valuable in promoting a more constructive and effective approach.

Flexibility

Tax systems should be sufficiently dynamic and flexible to keep pace with new developments. When greater use of technology can help to make compliance more efficient, such as through the increased use of e-filing or electronic payment, administrations should take a pragmatic approach to embracing these innovations. At the same time, there should be an acceptance of alternative forms of documentation as evidence, such as commercial documents rather than formal invoices.

Improving Compliance

While the simplification and harmonization of VAT systems would reduce the burden on MNEs, there are practical steps that businesses themselves can take to improve compliance. For example, they can review, modify, and monitor VAT compliance processes; standardize return procedures and documentation; increase automation and oversight; improve staff training; monitor VAT changes; and outsource their compliance functions.

If a standard approach can be extrapolated globally to all business operations, benefits will include lower costs from economies of scale and consistency from operating one efficient system. Of course, MNEs must still deal with the portion of their tax operations that cannot be standardized and that relates to specific national rules for each country where they do business. That is where certainty from the tax authority is seen as particularly important.

MNEs must take their multinational VAT compliance obligations seriously and ensure that they remain a management
Companies must build a culture in which compliance is seen as a fundamental obligation of every employee and must maintain clear communication between the tax function and lines of business. Such policies will help to manage risk and protect corporate reputation. On a global basis, MNEs should continue to devote resources to keeping abreast of developments that may affect their VAT positions, train staff, and adopt adequate VAT accounting processes and controls in recognition of the large volumes of VAT revenues that flow through their accounting systems.

MNEs must also ensure that there is continuity in their systems and processes to deal with organizational change. Problems often arise when businesses restructure, new information technology systems are implemented, or key staff leave. Companies should think through the implications of those changes and ensure that they occur with minimal disruption to their compliance obligations.

Establishing a better relationship between the MNE and national tax administrations can greatly increase certainty and help companies manage their level of tax risk effectively. Methods of strengthening relationships range from the informal to the highly formal and may include the use of binding rulings and taxpayer guidance, the adoption of new technology to allow taxpayers to fulfill their obligations remotely, and the allocation of designated tax inspectors. Many tax administrations will help educate taxpayers in order to assist them in developing sound systems and processes.

One recent trend that points to a greater openness and transparency between taxpayers and tax administrations is the development of enhanced relationship processes, such as the horizontal monitoring program in the Netherlands and the annual compliance arrangement in Australia. Not all tax administrations are willing to enter into this type of dialogue with taxpayers, but those that do are seeing great benefit from encouraging large taxpayers to adopt reliable processes and self-report errors in return for a lighter enforcement regime. Adopting a cooperative approach with taxpayers that demonstrate a willingness to take VAT compliance seriously allows tax
administrations to direct their scarce resources away from detecting errors to fighting and preventing organized VAT fraud.

Where to Go From Here?

Reputable businesses want to be fully VAT compliant, but complexities often make that difficult and costly. Reducing administrative burdens could improve VAT compliance for MNEs and free up the resources of tax administrations. Closer relationships between MNEs and tax authorities and continuing simplification and harmonization of VAT systems — especially within trading blocs such as the EU and the OECD — should facilitate consistent VAT compliance. Then, perhaps, achieving 100 percent VAT compliance may no longer be an unattainable goal.