In this edition we look at several aspects of how technology and globalization are having an impact on indirect taxes and on how tax and trade administrations and businesses are dealing with the challenges of the digital age.

Philip Robinson
Global Director – Indirect Tax

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*Indirect Tax Briefing* is published by EY.

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To learn more about EY’s global Indirect Tax network, please go to www.ey.com/indirecttax.

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Technology and globalization are rapidly changing how we live and how we do business, making cross-border trade far easier and far more prevalent in all sectors. In this edition of Indirect Tax Briefing we look at several aspects of how technology and globalization are having an impact on indirect taxes and on how tax and trade administrations and businesses are dealing with the challenges of the digital age.

Mismatches in the application of VAT to international trade can cause issues of double taxation and unintended non-taxation. We report on the OECD Global Forum on VAT and the adoption of the International VAT/GST Guidelines.

We consider how new VAT rules for the digital sector are being introduced around the world, focusing on the EU and South Africa and the proposals for the digital economy being put forward by the OECD. Pedro Meneguetti, Assistant Secretary for Finance for the Minas Gerais State Finance Office in Brazil, speaks to us about how the state’s tax administration uses data analysis tools to carry out more effective tax audits. And we report on how the South African tax authority (SARS) is using data analytics and sophisticated systems-based audits.

How can businesses respond to these trends? The executive summary of our recent report Managing indirect tax data summarizes our findings on how businesses can respond to the challenge of “big data” to
Welcome to the 10th edition of our *Indirect Tax Briefing*.

As with previous editions, this publication provides a mix of articles reflecting trends and developments in indirect taxes. Our global network of indirect tax professionals provides information and insights on developments and hot topics in a number of countries and regions.

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reduce risks and gain valuable insights and control. We also look at the particular indirect tax management issues that arise in the Asia-Pacific region. Our article sets out some of the indirect tax challenges that companies face while operating in this part of the world, which includes very developed VAT/GST systems (such as in Australia, New Zealand and Singapore) and new and developing systems (such as in China and Malaysia). We also consider ways that companies can proactively manage indirect taxes to go from dealing with day-to-day operational and compliance issues to incorporating indirect tax planning into corporate strategy.

In our country update section, we outline several developments that may increase taxpayers’ compliance obligations, including the differing opinions about the VAT rules on finance leases in Bulgaria, the impact of missing trader fraud in Russia and the need for *bona fide* companies to verify their suppliers’ credentials, the possibility that extra dutiable costs may apply to imports into Canada, and the new trade certification rules in Mexico.

Finally, we update our snapshot map of recent developments around the world.

We hope that you find this publication informative, useful and relevant to your business. We welcome your feedback. I can be contacted by email (philip.robinson@ch.ey.com) or by telephone (+41 58 286 3197).

Best regards

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VAT changes in the digital world

The digital world is ever expanding, rapidly changing and increasingly complex. Some commentators estimate that more than 200 new users connect to the mobile web every minute, but we have so far reached only 1% of our connectivity potential. The definition of the “digital economy” is also shifting to encompass a far broader range of industries and sectors than ever before. Tax authorities need to respond to these changes to protect tax revenues and avoid double taxation and nontaxation, a point that has been recognized by the European Commission, the Organisation for Economic Co-operation and Development (OECD) and a number of country tax administrations, including South Africa’s.

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1. The OECD consists of 34 member countries.
This article explores a global shift in the VAT rules for the digital sector, including some of the proposals put forward by the OECD and the changes being made in the EU and South Africa to apply VAT on supplies of e-services made by nonresident suppliers to local customers. We also look at some of the practical issues that digital companies face in dealing with the shifting tax landscape and how tax teams need to be engaging with commercial teams to reduce the compliance and commercial costs associated with these trends.

**BEPS and the digital economy**

The OECD published its Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan)\(^2\) in July 2013. This plan was in response to growing concern about tax planning by multinational companies using opportunities to reduce taxable income or shift profits to low-tax jurisdictions. One of the areas of concern was the growth of the digital economy.

The BEPS Action Plan notes that “The spread of the digital economy also poses challenges for international taxation. The digital economy is characterized by an unparalleled reliance on intangible assets, the massive use of data (notably personal data), the widespread adoption of multi-sided business models capturing value from externalities generated by free products, and the difficulty of determining the jurisdiction in which value creation occurs.”

In response to this issue, the OECD recently published a public discussion draft called “BEPS Action 1: Address the Tax Challenges of the Digital Economy.” Among others, one proposal that will be of significant interest to the digital sector is the taxation of remote supplies to digital consumers. The draft suggests that the most effective and efficient approach to ensuring the appropriate collection of VAT on such cross-border business-to-consumer (B2C) e-services is to require the nonresident supplier to register and account for the VAT on these supplies in the jurisdiction of the consumer. This approach is in line with trends in the EU and is gaining traction elsewhere around the world - with significant implications for businesses that provide e-services of all types.\(^3\)

**The EU: the 2015 VAT changes**

The OECD discussion draft specifically refers to the EU 2015 VAT changes\(^4\) as an example of a viable option for this approach. Broadly, these changes will apply VAT to all B2C supplies of “e-services” made in the EU in the EU country where the customer is resident. Therefore the rate of VAT charged on a digital service will depend on the country where the customer resides, not where the supplier is based. As such, this change is creating a number of practical issues for EU suppliers to face.

These issues are significant for digital businesses and taxing jurisdictions around the world because, in our experience, the 2015 changes have been far from straightforward to implement, with the European Commission working hard over a number of years to ensure a consistent approach and clarity within the legislation for businesses and tax authorities alike. However, despite the long lead-in time, with half a year to go until these far-reaching changes become effective, many suppliers are still grappling with the implications for their businesses, including the impact on customer contracts, prices, website design and reporting. For example, for some businesses, the VAT on their supplies will increase from 15% to 27% as a result of the 2015 VAT changes. What impact will that have? Can that increase be passed onto consumers? How does VAT apply for subscriptions that span the changeover date? These are all important practical concerns. Data storage and data protection issues may also arise as businesses may be required to keep customer data for more than 10 years under the 2015 VAT changes.

Of equal concern, we know that a number of EU Member States are not yet ready for the changes and may not be so by 1 January next year. Businesses are rightly concerned about what may happen in countries that do not have clear rules and practices in place.

**South African VAT changes**

South Africa has taken a similar approach to the OECD’s suggestion about taxing nonresident suppliers making digital supplies into the country (although it is not part of the OECD). However, South Africa has taken the rules one step further than the EU. It is looking to tax supplies of business-to-business (B2B) e-services as well as supplies to private consumers. This difference is likely to mean that many nonresident businesses will be impacted by these changes, even those that do not consider themselves to be typical digital businesses. Companies may be caught, for example, because they are selling some digital services as part of a wider package of B2B supplies.

Again, the rules have not been easy to implement, and the South African tax authorities have had to push back their implementation date from 1 April 2014 to 1 June 2014, not least because the difficulties with implementation arise from how to define the scope of “e-services” for these purposes.\(^5\)

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3. A range of materials related to the OECD BEPS and other related projects is available at [www.ey.com/beps](http://www.ey.com/beps)
4. An article setting out the details of the 2015 changes and their implications was featured in [Indirect Tax Briefing Issue 8 (September 2013)](http://www.ey.com/indirecttaxbriefing) on page 6, “VAT compliance issues for EU suppliers of e-services,” at: [http://www.ey.com/indirecttaxbriefing]
5. For a more detailed discussion on this point, please see the article at page 56 of this issue, “South Africa: New VAT rules for foreign suppliers of e-services.”
There is a general trend by governments toward taxation on nonresident businesses making digital sales into their countries.

As a result of the lack of clarity and the absence of available precedents in this area, many businesses are looking to obtain a ruling from the South African tax authorities as the only means of obtaining certainty on the tax treatment of their activities in this new world of taxation.

**Fixed establishment risk**

Businesses that do not trade in countries that are planning to introduce or have introduced changes on taxing e-services may believe that they will not be affected. This is not the case. Businesses operating in this space need to be mindful of any fixed establishment risk. Tax authorities may look to ensure collection of local tax on digital services by raising a challenge on the basis that the business has a local establishment from which it makes supplies.

As the business landscape changes, potentially so does the definition of "establishment." We have seen a number of cases within the EU addressing the point of what constitutes a supply made from a fixed establishment for VAT purposes. In the recently released Advocate General (AG) Opinion in Welmory Sp z o.o. (C-605/12), the AG suggests that for a fixed establishment to be created, a company must have a sufficient degree of permanence and human and technical resources to allow it to receive and use the services for its economic activities, even if those resources do not belong to it. Subject to the decision in this case, the definition of a fixed establishment for VAT purposes may be broadened, and thereby businesses (particularly multi-national companies with operations in multiple countries) could find that they have local fixed establishments where they did not previously consider there to be a risk. The growing number of indicators being put forward in this and other cases by the courts is making it increasingly complex for businesses to understand what exactly creates a fixed establishment. At the same time, it seems to be getting easier, and more common, for tax authorities to challenge a business on the basis that it has a local fixed establishment that should be accounting for local VAT.

**The global spread of this approach**

The OECD proposals, as well as the 2015 EU VAT changes and the South African VAT changes, represent a general trend by governments toward taxation on nonresident businesses making digital sales into their country. Other countries are looking at this area and many are prepared to act quickly. Countries that have recently discussed how to apply VAT to cross-border e-services include Turkey and the Bahamas. Further, although up until now these measures have generally impacted B2C sales, South Africa may serve as a warning that other countries could look to widen the VAT registration net to catch B2B deliveries as well.

Moreover, experience to date shows that the rules are rarely introduced smoothly. In practice, many issues are likely to arise, including establishing an agreed-upon definition of e-services covered by the rules, how to register overseas businesses, and how they can collect and report VAT charged and paid in each country.

Digital businesses expand rapidly into new markets. They must adapt quickly not only to unfamiliar tax jurisdictions but also to rapid changes in the tax rules that affect their activities. While traditional digital businesses are borderless in terms of trading, we also see that other traditionally non-digital businesses are offering more online products (for example, in the publishing and education sectors). As businesses of all types negotiate the commercial impact of this move to online delivery, their tax teams need to keep an eye on the shifting VAT rules and be conscious of the general tax trends in this area. Tax teams also need to be engaging with commercial teams from early on to reduce the compliance and commercial costs associated with the changes.

**Five key areas**

So what should taxpayers be doing now do to prepare for these changes? In the table below, we have identified five key areas to focus on, as well as the consequences of not taking action and the opportunities that arise from them:

1. **Pricing** – understand the impact of VAT and the potential impact of VAT changes on your pricing.
2. **Contracts** – ensure you understand who has responsibility for accounting for VAT.
3. **Systems** – ensure your customer acceptance, accounting and reporting systems are set up in good time for VAT accounting, and any changes in the VAT rules. Given the trends outlined, if you are undertaking major systems transformation, consider how you can future-proof system capabilities to deal with new VAT systems as and when they are introduced.
4. **Compliance** – understand the detail behind compliance (e.g., invoicing rules, exchange rates, audit procedures, storage of data).
5. **Customer experience** – ensure that the changes won’t impact how your customers experience your site or service. Consider aspects such as the need to collect personal information about where the customer belongs and storing customer data for long periods of time.

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6. Indirect Tax Briefing Issue 7 (May 2013), page 60 "Turkey: Online sales and services to non-business customers – who is liable for the VAT?" at www.ey.com/indirecttaxbriefing
### 5 key areas

<table>
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<tr>
<th>Key area</th>
<th>Do nothing/key risk</th>
<th>Take action now/key opportunities</th>
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| **Pricing**                             | - Multiple VAT rates across the EU not considered in pricing strategy  
- Erosion of revenues and profit margins due to increased tax costs  
- Inaccurate cash flow forecasting                                                                                                                                                                                                 | - Effective pricing strategy  
- Revenues and profit margins protected with no surprises over tax costs  
- Accurate forecasting of cash flow                                                                                                                                                                                                 |
| **Contracts with partners, vendors and intermediaries** | - Erosion of revenues and profit margins  
- Increased risk of financial penalties resulting in a cost to the business                                                                                                                                               | - Protection of revenues and profit margins  
- Low risk of financial penalties arising from failure to meet VAT obligations                                                                                                                                                     |
| **Systems**                             | - Increased risk of errors for high-volume, low-value transactions  
- Frequent manual intervention  
- Inefficient VAT management across multiple jurisdictions increasing operational costs and eroding margins                                                                                                                                                                                                 | - Low risk of errors for high-volumes, low-value transactions  
- Fully automated systems requiring minimal manual intervention  
- Accurate and efficient VAT management across multiple jurisdictions                                                                                                                                                     |
| **Compliance**                          | - Lack of awareness of local VAT rules in multiple EU countries  
- Increased risk of noncompliance resulting in penalties and reputational damage                                                                                                                                                 | - Timely and accurate VAT compliance obligations met timely and accurately  
- Reduced risk of financial penalties and reputational damage resulting from non-compliance                                                                                                                                               |
| **Customer experience**                 | - Customers are lost due to loss of one click order system  
- Data protection laws are broken  
- There is reputational risk                                                                                                                                                                                                 | - Customer relationship is managed  
- Data protection laws and tax laws are compiled with  
- Business maintains customers case                                                                                                                                                                                                 |
Some leading practices

Based on our experience of working with clients around the world, we have identified some leading practices that successfully help digital businesses avoid VAT pitfalls from entering new markets, marketing new products or from the changes to VAT rules happening in the EU, South Africa and elsewhere. They include:

Involving the tax team from the outset. Business moves quickly, and the tax team may not find out about the offering of new products in new markets until implementation is either imminent or has already started. The tax team needs good links in with the business to ensure that the tax impacts can be considered in good time and with the appropriate expertise. The tax team should be involved in the onboarding and approval process whenever a business launches a new product in a new territory.

Gather the facts. The tax team needs to have a clear understanding of the facts to fully assess the risks and compliance costs. This involves not only understanding the real-time issues but also being aware of forecasts and future plans for the business. Tax will need to feed into any new proposals as well as ongoing projects.

Establish clear customer agreements. Many contracts in the digital sector were entered into more than 10 years ago and the terms have not been reviewed or updated since. It is now more important than ever to ensure that all parties understand the supply chain and the responsibility for accounting for VAT. Otherwise a business may face assessments and fines for VAT where it was not aware that it had a liability.

Apply for local rulings. The introduction of new VAT rules is generally a good time to seek confirmation of the correct VAT position of supplies. This may be done, for example, by requesting a formal ruling, if it is possible to obtain one. In many cases there should be limited historical risk to the business as the tax rules are new for everybody, so there can be no past errors. Rulings can also provide certainty for businesses entering new and complex taxing jurisdictions.

Account for tax in the pricing of products and services. Tax teams should liaise closely with commercial teams to ensure that both parties have clarity regarding the impact of VAT on pricing. Decisions about pricing should not be taken in isolation by the tax team, or by the pricing team.

Develop policies and controls. The business should implement strong policies and controls to identify VAT risks and ensure an efficient and consistent compliance process.

Track and maintain documentation. Businesses need to ensure that they are prepared for audits and can provide clear audit trails to tax authorities when required in order to reduce risk and limit the time and resource costs associated with tax audits. Increasingly, tax administrations are using electronic data extraction to carry out more frequent and more in-depth inquiries and to share information. Digital companies should be prepared for these inquiries, potentially in a number of jurisdictions.
Conclusion

Tax teams in digital businesses face a unique challenge over the coming years. The pace of change in this industry, combined with evolving VAT changes, means that the cost of indirect tax compliance is likely to increase. To minimize cost and risk, companies that provide e-services will need to be well prepared for these changes and act quickly to fully understand the implications for their business. Tax teams cannot do this by themselves – they need to be increasingly well connected to different areas of the business to ensure that all affected parties in the organization understand the full implications, particularly in the areas of pricing, systems, legal and compliance.
Dealing with indirect tax data is the key to effective indirect tax management. But the variety of indirect tax data required by different jurisdictions and the sheer quantity of relevant data now generated by large organizations can present a range of logistical issues. In this report, we consider some of the challenges that multinational companies’ tax, trade and finance departments typically face in managing indirect taxes, including large quantities of complex transactional data, and we outline some of the management approaches and technology tools that can help them achieve their goals.

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The drive for better indirect tax data

Having accurate global indirect tax data — and examining it critically — has never been more important. What is driving this trend? How can companies use technology to gain more visibility of their indirect tax position? How can they manage indirect taxes and associated costs more effectively? And why is this issue “top of mind” for today's global companies?

External drivers

Governments are increasingly relying on indirect taxes — such as value-added tax (VAT), goods and services tax (GST), sales and use taxes, and customs and excise duties — to meet their budgetary needs. VAT rates have increased worldwide in recent years, and new indirect taxes are being introduced in many countries for sectors such as banking and energy. At the same time, the “fair tax” debate has put companies’ tax affairs firmly in the media spotlight, drawing intense scrutiny not only from tax administrations, but also from regulators, investors and even the public.

In response, tax and customs administrations are focusing more than ever on full compliance and using risk analytical tools to target their resources to tackle tax leakage and tax avoidance. They are requesting more information about companies’ transactions and where and with whom they do business. They are sharing more information with one another and comparing data from different businesses. They are doing more with the information they collect, using data analytic programs to detect errors, analyze transactions and carry out risk-based audits. And they are also expecting taxpayers to take full responsibility for adopting suitable systems and maintaining adequate control.

Internal drivers

Businesses around the world are under pressure to improve financial performance. And they are increasingly aware of the intense scrutiny they face from a range of internal and external stakeholders. In the process, they are asking more of their tax and finance functions, challenging them to reduce risks and meet the company's obligations more effectively, using limited resources. These functions are being asked to go beyond tax compliance — not just contributing to companies' financial performance by reducing costs, facilitating processes and improving cash flow, but also actively participating in strategic decision processes to provide financial and nonfinancial impact analyses.

At the same time, corporate models are changing. Increasingly, multinational companies are standardizing processes across entities and jurisdictions. They are rationalizing structures and consolidating technology platforms and reporting systems.

Until recently, most multinational companies organized their indirect tax compliance on a country-by-country basis, with little centralized coordination or oversight. It is now common for centralized indirect tax functions to submit returns for multiple jurisdictions — for example, using shared service centers (SSCs).

However, there is little harmonization in the information requested or the format for submission, which can make it difficult for centralized compliance functions to meet these demands. Gaining visibility over the financial impact of indirect-tax-related obligations, risks and opportunities is an important step to establishing an effective indirect tax strategy. It is often a precursor to building a business case for allocating resources and for making decisions about outsourcing and investments in technology.

Many companies face additional challenges related to customs and trade compliance, including import duties and taxes, which is often outside the scope of the tax department and often managed by third parties (such as forwarders or brokers), and it's where the taxes paid or saved are rarely visible in the company's commercial records and accounts.

Technology enablers

As corporations centralize their tax, legal and finance functions to reduce costs and increase efficiency, they are increasingly turning to technology to help them manage and measure tax performance. In the past, gaining global visibility on indirect tax data was difficult for most global companies to achieve because of the large number of relevant transactions and processes.

However, in recent years, advanced technologies, such as the internet and mobile phone applications, have changed the indirect tax landscape. Increasingly, indirect tax obligations are completed, filed and managed using technology tools; they increase accuracy, reduce processing times and costs, and raise visibility over the underlying transactions.

Improvements in managing data can be achieved quickly through simple enterprise intelligence (EI) tools. Mobile EI applications for smartphones and tablet devices are now readily available in large numbers. For example, data warehouse source feeds can be used for a real-time refresh of the information when the warehouse is updated.
High-performing global traders focus on data

Customs and trade compliance and costs are often outside the scope of the traditional tax and finance function. However, trade compliance is critical to companies whose business is dependent on the international flow of materials and goods. The “trade function” within such companies, wherever it sits, is responsible for maintaining key trade master data (tariff classification, country of origin, etc.); for managing any third parties, such as customs brokers, that make customs declarations for the company; and for ensuring that all exports and imports are correctly declared to the customs authorities.

Trade data accuracy and improved trade processes further operational agility, which is a key characteristic of high-performing companies. It does so by improving supply chain speed and reliability and by enabling accelerated response times, allowing companies to adapt flexibly to fast-changing circumstances.

The trade functions of high-performing companies rightly see their role as business critical, adding significant value through improved efficiency and operating cost reduction. These leading-edge companies are actively looking for new ways to use big data to improve international trade processes, uncover cost reduction opportunities and manage relationships. They rely on strong global or regional trade compliance controls and also involve IT resources as a part of the core trade team or effectively collaborate with IT departments – for example, to strengthen master data management, improve customs process efficiencies and derive increased customs duty savings through more effective use of trade agreement and customs regimes and concessions.

Through timely collection and meaningful analysis, data can be used to quickly move away from traditional reactive support roles to more proactive and strategic players within the organization that can improve trade processes and metrics, manage trade barriers, and reduce transactional costs. Flexibility and speed of response are clearly impacted in a positive manner, and significant opportunities arise for customs duty savings. This is particularly the case with data-intensive exercises such as free trade agreement optimization.

Data is essential for an effective management framework

Multinational companies are increasingly adopting a robust indirect tax management framework that rests on three aspects of indirect taxes: operational, compliance and strategic. However, it is still common for each of these aspects to be isolated and managed in a vacuum.

The challenge of big data is also its opportunity. Harnessing the power of the information they hold, companies can dig deeper into their indirect tax profile and uncover hidden costs, risks and opportunities. Through effective harvesting and analysis of indirect tax data, however, management can bridge the gap between operations, compliance and strategy by gaining visibility, control and insight. Managing indirect tax data is – and will continue to be – the key to aligning indirect taxes to the strategic goals of the business.

“Nice to have” today but “must-have” tomorrow?

As tax and customs administrations around the world develop their data analytic capabilities, it is crucial for taxpayers to do the same. Although many have started to invest in better indirect tax systems and standardized, automated processes, many more must still make progress in this area. And corporate management must begin to take indirect tax data needs seriously. Unless taxpayers use the same types of tools as tax auditors, they are at a disadvantage in the tax audit process and they are vulnerable to the consequences of unknown risks.

But, currently, this seems to be an area where corporations are lagging behind governments. The “wish list” for indirect tax technology – even in large companies – still often includes having more visibility, stability and certainty around basic data and processes. Several of the tax executives we interviewed for our report also mentioned wanting to have access to the same type of data analysis software used by tax auditors to identify errors and opportunities. Currently, this type of software remains on the wish list of many tax and trade departments. But as tax authorities continue to increase their use of data analytic tools, what is a “nice to have” today is likely to become a “must-have” tomorrow.
Managing indirect tax data for insight and control

Dealing with data is the key to effective indirect tax management. VAT, GST, sales tax, customs and excise duties are levied on imports, product movements, sales and manufacturing activity. They require large amounts of transactional data to be reported accurately and on time.

Meeting the varying demands of multiple jurisdictions and managing the sheer quantity of relevant data presents a range of logistical challenges. Tax, trade and finance departments in multinational companies all have to collect, report and archive large quantities of complex transactional data. Accurate data and the ability to examine it have never been more important.

Listen as our panel of professionals:

- Outline leading data management approaches and technology tools to help companies analyze indirect tax data more effectively, drive value and achieve strategic goals
- Analyze why this issue is “front of mind” for today's global companies
- Demonstrate how technology can offer more visibility of indirect tax positions
- Suggest effective strategies to manage indirect taxes and associated costs more effectively

Download the report at: www.ey.com/indirecttaxdata

Listen to the webcast in the on demand section at www.ey.com/webcasts
The second OECD Global Forum on VAT was held in Tokyo on 17 and 18 April 2014. The Global Forum could be judged to be a great success because it endorsed the OECD International VAT/GST Guidelines as a global standard to address issues of double taxation and unintended non-taxation resulting from inconsistencies in how VAT is applied to international trade.

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OECD Global Forums are a way of expanding the work of the 34 OECD member countries to the rest of the world, in particular to emerging economies.

The Global Forum on VAT gathered high-ranking officials from 100 jurisdictions and international organizations worldwide. Business representatives – including EY, and from the Business and Industry Advisory Committee (BIAC) to the OECD – were also invited to participate actively in all the sessions and had the opportunity to make presentations in almost all of the panels.

The Tokyo Forum was mainly dedicated to the OECD International VAT/GST Guidelines, in addition to presentation and discussion of general topics, such as global VAT policy trends and developments, the challenge of tackling VAT fraud, and the distributional effects of VAT reforms.

The International VAT/GST Guidelines

The guidelines are currently in a draft form as they are being developed using a “building-block” approach according to which “nothing is approved until everything is approved.” However, the guidelines now consist of a 60 page-document, comprising a preface and three chapters that the OECD Committee on Fiscal Affairs (CFA) officially approved on 29 January 2014.1 Therefore, they already constitute the international standard for the application of VAT/GST to international trade. With a view to reducing the uncertainty and risks of double taxation and unintended non-taxation, the two core topics of the guidelines are currently the principle of neutrality and the place of taxation of services and intangibles.

Neutrality principle: As far as neutrality is concerned, the OECD has developed and approved six guidelines (Guidelines 2.1 to 2.6) as follows:

1. The burden of value-added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation.
2. Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation.
3. VAT rules should be framed in such a way that they are not the primary influence on business decisions.
4. With respect to the level of taxation, foreign businesses should not be disadvantaged or advantaged compared to domestic businesses in the jurisdiction where the tax may be due or paid.
5. To ensure foreign businesses do not incur irrecoverable VAT, jurisdictions may choose from a number of approaches.
6. Where specific administrative requirements for foreign businesses are deemed necessary, they should not create a disproportionate or inappropriate compliance burden for the businesses.

The guidelines also contain commentaries that give useful guidance on their application in practice. It is worth stressing that the three last neutrality guidelines are specifically dedicated to foreign businesses.

The destination principle for taxing services and intangibles: With respect to the place of taxation of services and intangibles, the overarching principle is that VAT should be levied ultimately in the jurisdiction where final consumption occurs (Guideline 3.1). This is known as the “destination principle.”

B2B supplies: The current draft guidelines deal with the application of the destination principle only for business-to-business (B2B) supplies. In this context, the OECD has approved a general principle called the “Main Rule.” Guideline 3.2 states that according to the main rule: “For the application of Guideline 3.1, for business-to-business supplies, the jurisdiction in which the customer is located has the taxing rights over internationally traded services or intangibles.”

Applying the Main Rule to a legal entity that operates from a single location (a “single location entity,” or SLE) should be relatively straightforward in practice. However, applying the Main Rule to a legal entity that has establishments in more than one jurisdiction (a “multiple location entity,” or MLE) can be much more challenging. The OECD has therefore invested considerable efforts together with business representatives from BIAC to develop more precise guidance on the application of the Main Rule to MLEs. The adopted rule contained in Guideline 3.4 is that “For the application of Guideline 3.2, when the customer has establishments in more than one jurisdiction, the taxing rights accrue to the jurisdiction(s) where the establishment(s) using the service or intangible is (are) located.”

The guidelines reckon that three approaches may be appropriate for applying the principle laid down in Guideline 3.4:

• The direct-use approach, which focuses directly on the establishment that uses the service or intangible
• The direct-delivery approach, which focuses on the establishment to which the service or intangible is delivered
• The recharge method, which focuses on the establishment that uses the service or intangible as determined on the basis of internal recharge arrangements within the MLE, made in accordance with corporate tax, accounting or other regulatory requirements

Under the direct-use and direct-delivery approaches, the supply is taxed only once, whereas under the recharge method the supply is charged by definition several times at each stage of recharge until it has reached the establishment ultimately using the supply. The guidelines also contain practical commentaries on these approaches.

**Specific rules:** The guidelines admit that the place of taxation of services and intangibles cannot always be determined according to the Main Rule and that some specific rules may be acceptable. However, given the difficulty of reaching agreement among governments, the guidelines renounced setting a list of services and intangibles for which jurisdictions may adopt a specific rule. The preferred approach was to determine a set of conditions under which a specific rule may be adopted. This is laid down in Guideline 3.5:

“...The taxing rights over internationally traded services or intangibles supplied between businesses may be allocated by reference to a proxy other than customer location as laid down in Guideline 3.2, when both of the following conditions are met:

a. The allocation of taxing rights by reference to customer location does not lead to an appropriate result when considered under the following criteria:

   • Neutrality
   • Efficiency of compliance and administration
   • Certainty and simplicity
   • Effectiveness
   • Fairness

b. A proxy other than customer location would lead to a significantly better result when considered under the same criteria.”

**Guideline 3.5 on specific rules thus recommends a two-step approach:**

• The first step is to test whether the Main Rule leads to an appropriate result under the criteria set out under Guideline 3.5. Where this is the case, there is no need for a specific rule. Where analysis suggests that the Main Rule would not lead to an appropriate result, the use of a specific rule might be justified. In such case, a second step is required.

• In a second step, the proposed specific rule must also be tested against the criteria of Guideline 3.5. The use of a specific rule will be justified only when this analysis suggests that it would lead to a significantly better result than the use of the Main Rule.

The criteria laid down in Guideline 3.5, which are of particular importance for its implementation, are defined as follows:

• Neutrality: this involves the six guidelines on neutrality and their comments (Guidelines 2.1 to 2.6).

• Efficiency of compliance and administration: compliance costs for taxpayers and administrative costs for the tax authorities should be minimized as far as possible.

• Certainty and simplicity: the tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where and how the tax is to be accounted.

• Effectiveness: tax rules should produce the right amount of tax at the right time and the right place.

• Fairness: the potential for tax evasion and avoidance should be minimized while keeping counteracting measures proportionate to the risks involved.

Based on the approach suggested in Guideline 3.5, the guidelines reckon that at least for one type of supplies, namely for internationally traded B2B supplies of services and intangibles directly connected with immovable property, that the taxing rights may be allocated to the jurisdiction where the immovable property is located (Guideline 3.6). Here again, more concrete guidance is given in the text of the guidelines on situations and circumstances where this specific rule may be appropriate.
Conclusions and next steps

Although the guidelines are not legally binding and constitute only “soft” law, they can help businesses to interpret national law toward the tax administration. Moreover, they have a strong political impact and should contribute for businesses to the avoidance of double taxation. This is particularly true after they have been endorsed by 100 jurisdictions and international organizations at the Global Forum held in Tokyo.

The OECD will now deal with the next chapter of the guidelines concerning the place of taxation for supplies of services and intangibles to private consumers (B2C) and will present the completed guidelines for endorsement at the next meeting of the Global Forum in November 2015.
Strategically managing indirect taxes in Asia Pacific is no easy task to strategically manage a company’s indirect tax burden in the Asia-Pacific region. Unfortunately, there is no “one size fits all” management approach that can be deployed across such a diverse group of different countries and taxes. This article provides an overview of a report recently issued by EY, *The evolution of strategically managing indirect taxes in Asia-Pacific*, that is available at www.ey.com/indirecttax.

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Companies no longer have an option to avoid addressing their indirect tax risks and opportunities due to the heightened level of internal and external scrutiny in today’s world of taxation. Governments have recognized that a significant and growing proportion of their tax revenue is generated from indirect taxes, but they may not have placed a correlative amount of resources and effort toward ensuring compliance. Increasing trends in proactive enforcement together with internal recognition that the related indirect tax costs are not small are forcing companies to rethink how they view their indirect taxes. It is clear that it has never been more important for companies to focus on managing their indirect tax burdens in Asia-Pacific and around the world.

Asia-Pacific countries have a wide range of different indirect taxes that can create operational hurdles and result in significant tax costs if not managed appropriately. The different taxing regimes, even though in the same region, complicate matters even more as they are all in different states of maturity and development. But at the same time there are a lot of similarities that can also be leveraged for those taking a regionally coordinated approach to managing indirect taxes. For example, data is the same everywhere, and getting behind the data will help identify risks and opportunities.

As companies begin to better manage the operational, compliance and strategic areas of their indirect tax business, we are confident you will see continuous improvements to the overall operations. This work requires a certain level of technical expertise but also needs to have clear ownership and accountability to achieve the desired objectives. We would suggest considering the following approach to bridge the gaps between the indirect management framework and more closely align the operational, compliance and strategic aspects of your business:

**Closing the gaps in indirect tax management**

As we can see below, in the current state most companies still have wide gaps between the operational, compliance and strategic aspects of indirect tax management. Through concentrated and targeted efforts, we believe that the gaps can be shrunk and that closer alignment between these aspects will yield valuable benefits that enhance overall indirect tax performance.

We have surrounded the operational, compliance and strategic aspects of the indirect tax management framework with data because this is a constant in all parts of the indirect tax operations. It is interesting to note that a company will have more detailed VAT/GST data than the tax bureau, while the customs authorities are likely to have better data than the company. For many of the other indirect taxes we have covered in this report, the data is spread across many systems or locations. If a company is able to get behind the transactional-level data to perform detailed analysis and ensure consistency across the different aspects, then we believe that significant benefits may be achievable.
EY has recently published an indirect tax thought leadership report regarding the management and use of indirect tax data to improve operations, enhance indirect tax performance and identify risks/opportunities available to the company. We would like to re-emphasize the importance of obtaining, analyzing and then using the results to improve the strategic management of indirect taxes in Asia-Pacific. This is the future of indirect tax management, and we recommend companies to embrace this approach sooner rather than later — especially since the customs authorities and tax bureaus are also headed in this same direction.

We have outlined five priority focus areas that companies should consider undertaking to close the gaps and more closely align the aspects of the indirect tax management framework. While there are numerous ways to begin this journey and make strides to more effective indirect tax management, we suggest to:

1. Build the company’s Asia-Pacific indirect tax profile and map all flows of goods and services to a description of their indirect tax treatment. Many companies still have limited visibility into the indirect taxes applied on their goods and services across the region. Some are not even clear what goods and services may be subject to indirect taxes or how much indirect taxes are actually being incurred. Accordingly, it is essential that the company compile an indirect tax profile of the types of indirect taxes applicable to the goods and services that result in tax costs, cash flow impact and operational/compliance obligations incurred by the organization. This level of qualitative and quantitative visibility will help to elevate the indirect tax discussion on management’s agenda.

2. Conduct a thorough review of systems and end-to-end indirect tax processes to complete the understanding of how transactions are handled and where data resides in the IT systems. Once an indirect tax manager has a view of the end-to-end processes they can begin efforts to close gaps but also introduce recommendations to improve overall indirect tax performance.

3. Improve compliance through increased use of IT systems, automation, standardization and possibly centralization efforts. Indirect tax compliance has historically been performed by the local business units with little consideration for how other countries process their indirect tax returns. Through regional involvement it is possible to improve consistency and standardization across the Asia-Pacific region, and the company should be able to benefit with enhanced processes and improved compliance from these efforts.

4. Perform detailed data analytics to understand your profile, target risks and opportunities but also to prioritize strategic efforts. Results from the analysis on transactional-level data and information from the submitted returns can more readily guide the indirect tax manager toward priority areas of focus. Obtaining your data is a first step in the process, but once data is available the types of value-add analysis can be almost limitless when playing with the data.

5. Establish an organizational structure to manage the indirect taxes on a local/regional basis while at the same time moving up the management continuum from operational and compliance to more high-level strategic activities. An internal structure that supports the development of the indirect tax function in regional/local matters and reinforces the involvement and authority of the manager in the end-to-end indirect tax processes is needed to realize improvements.

Asia-Pacific countries have a wide range of different indirect taxes that can create operational hurdles and result in significant tax costs if not managed appropriately.
A reasonable approach to starting this indirect tax management journey can begin with the developed countries (e.g., Australia, Singapore, New Zealand) where it is possible to obtain and gather a more complete picture of the indirect tax landscape with lower risk of getting things wrong. This may seem counterintuitive since the first instinct of most companies is to immediately focus on the most complex and developing locations. We see many businesses that want to begin evaluating their indirect tax operations and performance in complex countries like China, Vietnam and Indonesia because this is where the burning platform issues are arising. While this may be your first instinct, we would recommend the benefits of considering a different starting point.

Consider this: it is the developed countries where the access to actual data is most available (even directly from the authorities); the internal/external systems are more developed; the flows of affected goods and service transactions are well-known and have already been addressed by experienced indirect tax resources; the tax authorities have practical experience and are used to open dialogue with taxpayers; and the entity has a relatively lower risk profile. All of this may result in a deeper understanding of the indirect tax profile and end-to-end processes that can more easily be leveraged to other less developed locations. Therefore, companies should seriously consider starting the evolution of strategically managing their Asia-Pacific indirect taxes from countries such as Australia and Singapore. The indirect tax manager can use these findings to extrapolate to the developing countries, which could yield better results for the amount of effort expended. These can then be leveraged to other more complex regimes around the region. We are not suggesting to ignore, forget or deprioritize the other countries, since there are hot issues that need to be urgently addressed. Rather, we are recommending that if a company wanted to start a holistic and comprehensive approach to understanding the indirect tax operational, compliance and strategic aspects of the business, then the developed countries are a logical place to begin.

Where to start?

Conclusions

Gaining effective control of your Asia-Pacific indirect taxes is an evolutionary process that will take time. The current starting point for many companies today is: not much understanding of indirect taxes in the region, limited visibility into the detailed transactions that underpin the indirect tax position, little automation to create efficiencies and no definition of who is responsible for managing the indirect tax function. This is true since there are very few experienced indirect tax resources who are fully dedicated to understanding the indirect tax matters faced by the business and are able to oversee compliance and execute on strategic objectives.

All companies will be at different points of maturity in this evolutionary process, but it is important to start now or keep the momentum moving forward. We see the future of indirect tax management being where a company has dedicated indirect tax roles and responsibilities with staff who operate in a centralized manner with a standardized and consistent reporting framework of how to manage the operational, compliance and strategic aspects of the business. This is what we tend to see in more developed countries, which have been proactively managing indirect taxes for years or decades. Asia-Pacific will get to this point, but it will take time and effort to make it happen.
Our survey of 830 tax and finance executives in 25 jurisdictions, completed in January 2014, indicates that the tensions described in our previous reports pale compared with the tax risks that companies are experiencing and anticipating. Eighty-one percent of all companies surveyed agreed or strongly agreed that tax risk and tax controversy will become more important for their companies in the next two years.

The results of this survey offer a glimpse of the hazards that must be overcome in order to safely navigate the next steps of the journey. It is clear that many companies may wish to consider enhancing their preparations and their tools in order to bridge the divide between current and future risk management frameworks.

Our survey reveals four major sources of tax risk:

1. Reputation risk
2. BEPS and legislative risk
3. Enforcement risk
4. Operational risk

In the first of a series of reports, Bridging the Divide: Highlights from the 2014 Tax risk and controversy survey, we note the most significant survey findings and sets the stage for deeper exploration of key topics in the subsequent editions.

Download the report, read our survey results or benchmark your company at

www.ey.com/taxriskseries

Listen to our webcast where our panel of professionals to explore the challenges revealed in the survey to gain insight into some of our key findings. Go to the on demand section at

www.ey.com/webcasts
Other views and analysis from EY's tax professionals

**Global trade management: high performers move ahead**
This report provides the findings from the EY Global Trade Symposium, where top trade executives from some of the world's largest global traders exchanged ideas about how global trade management can give high performers a competitive edge.

[www.ey.com/globaltrade](http://www.ey.com/globaltrade)

**Worldwide VAT, GST and sales tax guide**
Our *Worldwide VAT, GST and sales tax guide* helps you understand how indirect taxes will affect your company abroad. Chapter by chapter from Albania to Zimbabwe, this guide summarizes consumption tax systems in 110 jurisdictions and the European Union.

[www.ey.com/vatguide](http://www.ey.com/vatguide)

**TradeWatch — Global trade**
*TradeWatch* is our global trade quarterly publication that spotlights customs valuation developments and also includes global trade updates from countries and regions around the world.

[www.ey.com/globaltrade](http://www.ey.com/globaltrade)

**TPC Briefing — June 2014**
The latest edition of the quarterly *Global Tax Policy and Controversy Briefing* provides coverage of the latest developments on the OECD's action plan regarding base erosion and profit shifting (BEPS), as well as detailed updates from various jurisdictions around the world.

[www.ey.com/tpcbriefing](http://www.ey.com/tpcbriefing)

**Indirect Tax in 2014**
How do you keep pace with today's rapidly changing indirect tax landscape? Our high-level overview of global trends and developments will help.


**Worldwide Corporate Tax Guide**
This guide summarizes the corporate tax regimes in 161 countries.

[www.ey.com/tax](http://www.ey.com/tax)

**Tax Insights**
This periodical magazine focuses on the dynamic tax environment faced by companies operating across the globe. The theme of this edition is the future of tax.

[www.taxinsights.ey.com](http://www.taxinsights.ey.com)
As the global economy recovers, indirect taxes continue to play an important tax policy role. Laws develop and change at a rapid pace. Keeping up to date is a challenge for all involved with indirect taxes.

This graphic displays some of the indirect tax changes (agreed and proposed) that have taken place across the world in recent months and those that are due to take place later this year and beyond.

These changes supplement those set out in our report, *Indirect Taxes in 2014* and in previous editions of *Indirect Tax Briefing*, both available on (www.ey.com/indirecttax)

**Luxembourg**
1 January 2015: standard VAT rate will increase to 17% (from 15%), reduced VAT rate will increase to 8% (from 6%)

**Honduras**
1 January 2014: GST rate increased to 15% (from 12%)

**Portugal – Azores**
1 January 2014: standard VAT rate increased to 18% (from 16%), intermediate VAT rates increased to 10% (from 9%) and reduced VAT rate increased to 5% (from 4%)

**Portugal**
2015: proposed increase in the standard rate of VAT to 23.5% (from 23%)

**Mexico**
1 January 2015: excise tax is payable on certain temporary imports on which the tax was previously waived

**Spain**
1 January 2014: cash accounting scheme introduced

**Dominican Republic**
1 January 2015: standard VAT rate will be decreased to 16% (from 18%)

**Bahamas**
1 January 2015: VAT to be introduced (postponed from 1 July 2014)

**Suriname**
1 January 2014: VAT was to be introduced but has been put on hold
China (mainland)
1 June 2014: VAT pilot program to be extended to cover telecommunications sector

Croatia
1 January 2014: reduced VAT rate increased to 13% (from 10%)

Czech Republic
1 January 2016: single uniform VAT rate of 17.5% will apply

Hungary
1 July 2014: new tax point rules for continuous supplies

Italy
6 March 2014: Repeal of part of the recently introduced tax provisions concerning certain digital economy activities

France
1 January 2014: standard VAT rate increased to 20% (from 19.6%) and intermediary rate increased to 10% (from 7%)
1 January 2014: all newspapers and magazines, including those in electronic format, are subject to a super-reduced rate of 2.1% (previously standard rated)

Poland
Temporarily increased VAT rates of 23% (standard rate) and 8% (reduced rate) will continue until the end of 2016

Romania
1 January 2014: monthly list of domestic sales and purchases (Form 394) required

Egypt
The introduction of VAT with a standard rate of 10% to 12% (to replace the existing GST regime) is being discussed - proposed date not yet available

Seychelles
1 January 2014: VAT refunds available for visitors

Japan
1 April 2014: consumption tax rate increased to 8% (from 5%)
1 October 2015: consumption tax rate will increase to 10% (from 8%)

Europe
1 January 2015: final phase of VAT package to be introduced
The VAT place of supply for B2C supplies of e-services, broadcasting and telecommunications services will be the customer’s country in all cases

China (mainland)
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Brazil

How technology is used by the tax authority

Sergio Fontenelle, EY Indirect Tax leader for South America Region and Brazil, met recently with Pedro Meneguetti, Assistant Secretary for Finance for the Minas Gerais State Finance Office. They talked about the role of technology in helping Brazil’s Minas Gerais State collect indirect taxes and audit taxpayer activity.

Sergio Fontenelle
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Sergio Fontenelle: What is the function of the body you are responsible for, and how is it organized and structured to run its activities?

Pedro Meneguetti: I have been a tax auditor at the State Revenue Services for 28 years now, currently as an Assistant Secretary for the Minas Gerais State Finance Office.

The Minas Gerais State Finance Office contains the highest hierarchical level, which is the staff of the Finance Officer. This structure is subdivided in two suboffices: the State Revenue Services, which is focused on tax management, and the State Treasury, which is engaged into the financial management and public spending.

The Assistant Secretary’s role also involves acting as the immediate Deputy Finance Officer, which includes participating in the management of the State revenues and expenditure. I support the State Finance Officer to effectively control public spending to meet government policies, and I analyze and monitor credit operations.

On the tax administration side, the State Finance Officer appointed me as a leader of the decision-making process in the tax policy realm, supporting and proposing measures to the Government of the State of Minas Gerais to formulate tax and fiscal policies across the state and across Brazil.

Sergio Fontenelle: Do you agree that there is a trend for tax authorities to share more information with other authorities, including different levels of the Government? If so, could you please give us examples?

Pedro Meneguetti: I fully agree! That trend is a real fact nowadays. As far as tax authorities are concerned, I believe that sharing information should no longer be seen as a legal power, but as an obligation.

At present, the State Finance Office is party to agreements to share information with a number of bodies, at various government levels. Countless joint associations and agreements have been entered into, such as the agreement with the Brazilian IRS (tax administration) involving the exchange of information and provision of the database of taxpayers’ income tax returns; with the National Department of Mineral Production (DNPM) to exchange information and data on exploitation and treatment of Brazil’s mineral production; and with municipalities of the State of Minas Gerais to cross-check local property tax (IPTU) data and the municipal systems for real estate valuation, in order to enhance the state estate and gift tax (ITCD) levy.

Also, with under specific legislation, information is provided by debit and credit card companies, which through data cross-checking has helped us to determine the value of transactions undertaken by state VAT (ICMS) taxpayers. We also share information and experience with regulators, namely the Brazilian Drug Administration office (ANVISA), and the National Oil Agency (ANP), among others. They all contribute to sweeping efforts to control and inspect significant economic segments, and they have high social appeal. But I would like to add that all these agreements and obligations meet the legal provisions and precepts of tax confidentiality.

Sergio Fontenelle: What is the goal set by the Government to collect indirect taxes? What are the main barriers to meeting these goals?

Pedro Meneguetti: First of all, with regard to indirect taxes levied on goods and services, I should point out that in Brazil they are collected at three government levels, i.e. federal, state and local. Therefore, my comments always focus on ICMS, which is a state tax levied on goods in general and communication and transportation services.

The State Government’s annual budget should be based on its own revenues and transfers from the Federal Government. Although the states more often than not disagree with the amounts passed on by the Federal Government, they have not been able to intervene.

In the light of these budgetary needs, the State Finance Office has been focusing its actions on a consistent management model. We have designed an annual plan that sets stretching goals aimed mainly at intensifying our tax control and eventually we aim to recover and expand tax and non-tax revenues, besides having goals to increase the Government’s investment capacity. These goals are based on an overall economic analysis, historical data from recent years, discussions and trends toward political and tax reform, besides a number of other factors.

The main barriers to putting the planning into practice come from national and international economic changes. An example was the global crisis in 2008 which deeply affected revenues in the State of Minas Gerais. Another example is when the Federal Government established the tax relief on industrialized products tax (IPI) and income tax (IR) for major appliances and for the automotive industry. That deeply eroded the revenues of states and municipalities in Brazil, and it was reflected in the amounts passed on to us, besides reducing the taxation base for ICMS. Also the tax framework that we operate in, consisting of
legislation for 26 Brazilian states plus the Federal District, broadens the tangled web of tax laws, not to mention the possible benefits that may be granted by the states as a result of the so-called “tax war.” These factors are all barriers to meeting our revenue goals!

Sergio Fontenelle: How often are indirect taxes audited?

Pedro Meneguetti: The population of ICMS taxpayers in the State of Minas Gerais is very large, with nearly 700,000 active taxpayers on the roll. Economic segments, groups of taxpayers and specific taxpayers are selected to build up the portfolios of taxpayers to be audited based on certain indicators and our departmental plans.

Planning also includes identifying the best way to approach audits and the frequency of audits, since in some segments the tax work involves large data amounts and cross-checking information using the various tools and audit techniques currently at the auditor's disposal.

I should also say that the complexity of some industry segments and the significance of their revenue results require ongoing monitoring.

Sergio Fontenelle: How does the Government select taxpayers for audit (e.g., through a continuous program, through risk assessments, through information from other bodies, based on information obtained by other companies, etc.)?

Pedro Meneguetti: Taxpayers are selected through a series of techniques and the intensive use of economic and fiscal information. We have analytical intelligence tools which allow us to segment taxpayers according to their characteristics and their structure and according to the level of tax issue requiring corrective action. The sources of information are multiple, and they are not restricted to the data supplied by the taxpayers themselves, but they also extend to information shared by other external bodies, e.g., the Brazilian IRS, city halls, the commercial registry and so on.

Sergio Fontenelle: Does a specific department deal with large indirect taxpayers?

Pedro Meneguetti: There is no specific large taxpayer department at the Minas Gerais State Finance Office, but there are teams specializing in large taxpayers in all the regional units. Taxpayers are structured into economic segments, and on the basis of economic and fiscal indicators and other external data taxpayers are selected and classified in view of different types of approach to fiscal control. Large taxpayers are monitored on an ongoing basis, besides being often subjected to in-depth audits whenever an indication of a deviation is detected.

Sergio Fontenelle: Do auditors use any tools to look into data which identifies errors/risks in indirect tax returns?

Pedro Meneguetti: Yes, in recent years the Minas Gerais State Finance Office has made great strides in the organization, treatment and use of fiscal information. One of the initiatives consisted of organizing a large, single database to extract information from the various electronic sources — e-invoice (NF-e), e-waybill (CT-e), digital tax bookkeeping (EFD), etc. — to allow us to expand and streamline the flow of fiscal cross-checks. Also, in a project internally named i-Fisco, the State Finance Office has recently deployed an analytical intelligence tool that leverages the use of information for decision making.
Sergio Fontenelle: Could you explain how indirect taxpayers electronically report the details of their transactions? And why taxpayers are required to perform this procedure?

Pedro Menequetti: The same law which establishes the obligation to pay the tax also sets out supplementary obligations aimed at determining that the payment is correct. Therefore, taxpayers are required to provide information about their activities by law. When an NF-e or CT-e is issued, the taxpayer already starts providing this information, which is promptly put into the tax authorities’ databases. The taxpayer issues the document, sends it to the database of the tax authorities, and it is then given an e-proof of authorization. Once this authorization is given, the document is valid until a given date. In addition to the NF-e and the CT-e, the taxpayer files some other statements, such as the ICMS calculation statement, which reports the whole tax calculation for the month, and the digital tax bookkeeping, which has superseded the former tax registers for incoming goods, outgoing goods, calculation, etc.

Sergio Fontenelle: Do the auditors use data analysis tools to identify errors/risks or to support tax audits? How does the government intend to maximize the use of the technology to make audit even more efficient?

Pedro Menequetti: The Minas Gerais State Finance Office is in a transition period regarding our “fiscal control” model (that is, our management model and related inspection methodologies). This applies also in connection with the adoption of new technologies and the new scope of the information in electronic format.

In 2004, we kicked off the project for modernizing the State Revenue Service, including a specific initiative seeking fiscal control. Accordingly, robust investments were made in our technology infrastructure (hardware, software and network connection resources), management structure, work and development methods, and technical training. Two of these initiatives were based on having electronic economic and fiscal information. The investments allowed us to deploy a new layout in fiscal control management at the state level, incorporating a specialized fiscal intelligence unit, a digital audit laboratory and regional digital audit cells. At the same time, we revised and updated our road maps and fiscal audit techniques, consolidating the contents into a Tax Audit Manual (MAF).

One of our most significant recent investments involves building an extensive electronic database of taxpayer information (statements, payments, e-invoices, credit card transactions, among other things) integrated into GIFT (the economic, fiscal and tax information management system). Another has been the consolidation of the i-Fisco project, which has advanced tools and uses high-end techniques related to analytical intelligence and to find and produce strategic information.

This transition process is bringing a new era for the tax auditor, where his or her raw material – that is, economic and fiscal information – is solely in electronic format. This is why we are revising our paradigms and discussing, planning and structuring a new fiscal control model, a model based solely on the digital tax audit. The complexity of this new scenario, whether in connection with the volume or the variety of information and formats, requires a new methodological approach. It is clear to us that the results achieved by our auditors up until now can no longer be built on our current.
work methods. An extensive set of new components will redesign the “new digital audit” to allow the auditor to ask: What? Why? Where? When? Who? We are building a new work standard, based on the integration and intensive use of the new technologies to respond to these challenges.

Sergio Fontenelle: Does the Government expect taxpayers to use technology to control their compliance with their indirect tax obligations (e.g., determination of rates and statistics)? Do e-taxpayers expect more accurate and assertive audits, since more tools are available?

Pedro Meneguetti: The deployment of digital tax documents and the use of analytical platforms represent an important change in paradigm for the tax authorities to act and in the relationship with the taxpayer. Data obtained and processed from these documents will provide the tax authorities with a level of direct and detailed knowledge of the economic and fiscal reality for each economic sector, collection regime and region that we have not seen up until now.

This scenario suggests there will be more stringent audit controls, but actually it really just supplements the guidelines that the tax authorities of the State of Minas Gerais have been pursuing for nearly two decades – that is, to promote taxation focused on the characteristics of the taxpayers’ economic activities. The tax authorities are basically interested in a taxpayer being able to keep an appropriate and equal tax payment capacity in relation to its economic capacity. Increased collection depends on the economic growth of the state and therefore the increase in each taxpayer’s business. To date, this guideline has been adopted through sectoral monitoring of taxpayers and various studies. Digital information and the new potential for design provide the tax authorities with insight into the dynamics of each business and allow us to run structured analyzes on the economic reality of each sector. Therefore, taxpayers may expect the tax authorities to enhance our actions to support the growth of economic activity, which allows the authority to become an important partner in expanding business as it is aware of turnover, commercial flows, and purchase and sale profiles of each sector. Accordingly, in relationship to the entities representing the business community, the tax authorities of the State of Minas Gerais will play an important role not only in increasing development, but also in securing equitable taxation in a truly competitive business environment.

Sergio Fontenelle: Does the Government believe that taxpayers who meet their tax obligations should be rewarded in some way?

Pedro Meneguetti: The protection of public revenues is an initiative which should bring together government and society. Raising awareness of the social and economic functions of tax should be shared among all citizens, which actually brings business owners and administrators into the loop together. Fair collection and the social application of public funds are the best reward that taxpayers and society should seek.

Sergio Fontenelle: Among the Government metrics, is there a correlation between the corporate governance level and sustainability actions undertaken by companies and the quantitative aspect (calculation base and rate) of indirect taxes?

Pedro Meneguetti: The State of Minas Gerais understands that companies are our partners and customers – as the driving force of the state activity is through tax collection. For this partnership to come into being, the State studies and works in association with economic segments to set rules on the actual payment of taxes due. As an example, we may cite the various margins of added value set for economic sectors taxed at the beginning of the production chain, agreed with the representatives of each economic sector.

Sergio Fontenelle: What measures does the Government adopt (or intend to adopt) to efficiently identify and charge indirect taxes on activity carried on in cyberspace?

Pedro Meneguetti: Currently, the state VAT (ICMS) related to electronic commerce is fully due to the state of
origin whenever the counterparty to the transaction is an end consumer (as set out in paragraph 2, article 155 of the Federal Constitution). Taxation is distributed among the respective states only when the counterparty is an ICMS taxpayer. Brazil’s Senate is presently evaluating Proposed Constitutional Amendment No. 197/2012, which establishes tax sharing in all cases. While this measure is pending approval, the State of Minas Gerais has been making efforts to attract e-commerce companies into the state. Another point to be considered is taxing international sales in cyberspace, such as software sold on the internet. In this case taxation will depend on a complex study of the case, since this problem affects other countries. Solutions implemented in the countries where the VAT is centralized at federal level might be used in Brazil, preserving our tax individuality vis-à-vis the tangled web we have of 27 ICMS legislations conflicting with thousands of service tax (ISS) legislations.

Sergio Fontenelle: Thank you so much for sharing your insights with us. Do you have anything you’d like to add?

Pedro Meneguetti: Yes, thank you! Finally, I would like to say I understand that voluntary compliance with tax obligations and the perception of risks by taxpayers is associated with the baseline mission of the tax administration. Taxpayers should have a perception of the risk involved in decision-making to comply with tax standards in view of the enhanced IT control through mandatory filing of statements and electronic documents. Concurrent with this point is the receipt of information shared with various government bodies, obligatory information from credit card companies and the bank system organized into a single database which allows cross-checks of information and analyzes of deviations found.
In November 2013, the Bulgarian Parliament voted for fundamental changes in the VAT treatment of finance leases. The draft law did not raise much discussion in Parliament, but it has already caused turbulence among lessors. The new rules, effective 1 January 2014, stem from an interesting Bulgarian referral to the European Court of Justice (CJEU) with consequences for lease companies with both individual and business clients.
The VAT position prior to 2014

The VAT treatment of leases has been a frequent subject for discussion in Bulgaria. In fact, no other type of transaction has triggered so many changes in Bulgarian VAT law!

It all started in 2005, when, preparing for its upcoming EU accession, the Bulgarian Ministry of Finance (MoF) considered taxing finance leases as sales of goods, referring to the Sixth VAT Directive’s rule 1 regarding sales on deferred terms. However, this treatment raised concerns among businesses and, after comparing the models applied in different EU Member States, it was established that some states tax finance leases as a supply of goods while others tax it as a service.

Subsequently, a more complicated but flexible model was adopted. It allowed the parties to determine the VAT tax point for a lease depending on whether the leased item will or may be acquired. This could be done at the beginning of the lease when the transfer of title at the end was certain (called in practice a “closed lease”) or proportionately according to the installments when the transfer of title was optional (called an “open lease”). These rules still caused numerous disputes between taxpayers and the tax authorities, but, with small amendments, they survived until 2013, when a Bulgarian case at the CJEU provoked the MoF to reconsider when VAT arises on finance leases.

Eon Aset case and finance leases

The CJEU case C-118/11 Eon Aset Menidjmunt OOD concerns a dispute about the private use of cars leased by a Bulgarian company, affecting the lessee’s right to input VAT deduction. It did not relate to the issue of finance leases; however, the lessee’s defense shifted the dispute in that direction.

The company claimed that, although there is no evidence that the cars were used for business purposes straight after their acquisition, the cars were actually booked as assets by the company. Hence, the company argued, the capital goods scheme should be applied to their VAT recovery (i.e., their use should be followed over a five-year period following the initial input tax deduction) and adjusted accordingly. In other words, if the cars were capital goods and were used for business purposes in that five-year period, the company could deduct some of the related VAT on their acquisition.

The case was referred to the CJEU. In order to answer the questions referred by the national court, the CJEU decided to first interpret the VAT treatment of leases in general. What many VAT practitioners found surprising was that the CJEU referred to International Accounting Standard (IAS) 17 on leases to define finance leases for these purposes. According to IAS 17, a finance lease transfers to the lessee substantially all the risks and rewards of legal ownership. Accordingly, the CJEU said that “where a financial leasing contract provides either that ownership is to be transferred to the lessee on the expiry of that contract or that the lessee is to possess all the essential powers attaching to ownership and, in particular, that substantially all the rewards and risks incidental to legal ownership are transferred to the lessee and that the present value of the amount of the lease payments is practically identical to the market value of the property, the transaction must be treated as the acquisition of capital goods.”

The impact of the CJEU decision on Bulgarian VAT law

The MoF interpreted the CJEU’s decision as a sign that the Bulgarian legislation did not comply with EU VAT law. This conclusion led to a legislative proposal that all finance leases should be taxed upon the handover of goods not only when the transfer of ownership is certain but also when (1) it substantially transfers all risks and rewards to the lessee and (2) the lease installments are identical to the fair value of the goods.

In the final version of the new rules, introduced with effect from 1 January 2014, only the last of these conditions was adopted, so that what was left was only a technical comparison between the value of the lease installments and the market value of the leased goods.

Does the change bring Bulgaria into line?

The proposed change in the VAT law on leases was motivated by a requirement to comply with Eon Aset Menidjmunt. However, we disagree with the view that Eon Aset Menidjmunt requires a change in the Bulgarian legislation on tax points for finance leases.

1. Article 14(2)(b) of Directive 2006/112/EC
In our view, the case was all about VAT deduction rights, not about the VAT treatment of leasing.

**Capital goods**

In our view, the case was all about VAT deduction rights, not about the VAT treatment of leasing. The reason for the Court looking into IAS 17 was not to determine whether this was a finance lease but to answer the taxpayer’s claim that the capital goods scheme should be applied to the cars acquired. It should be noted, in this context, that ever since the introduction of the capital goods scheme in Bulgaria, it has had a broad range and has applied to “assets according to the accounting standards.” Circumstances such as the possession of all the essential powers related to the ownership or whether the lease installments equated in practice to the market values of the property were considered by the CJEU as criteria for qualifying a lease transaction as an acquisition of capital goods — and, hence, to distinguish it between an acquisition of capital goods and an acquisition of ordinary goods.

This point is crucial. For “ordinary” goods, the business use that is a condition for input VAT deduction is at the time of acquisition — it is not to be judged over a longer period. For “capital” goods, however, the business use is judged over a five-year period.

**The Lennartz principle:** In the case at hand, the qualification of the acquired cars as “capital goods” also switched on the application of the “Lennartz principle”. Under this principle, a taxable person knows how he will use an acquisition and applies the appropriate VAT treatment. But if the goods are not fully dedicated to business use, VAT that was initially deducted must be paid back.

**The impact of the judgment**

In summary, the judgment in Eon Aset Menidjmunt allows goods acquired under finance lease contracts to be treated as capital goods (assets) for VAT deduction purposes. However, reading this as a requirement to pull forward the taxable point to the moment of handover of the goods is, in our view, excessive.

First of all, the change creates uncertainty. The previous rules gave the parties to the finance lease contract flexibility to determine the applicability of VAT, either proportionately to the installments or as a one-off at the start. Under the change, even in cases where the parties do not wish to change ownership when handing over the goods, they must consider other criteria to determine when VAT is due. These decisions may not always be easy to make. For example, it may seem easy to determine whether the lease installments are equal to the market price of the goods. However, market prices vary, and the CJEU has previously ruled that market process cannot be freely used as a guideline for the attribution of VAT consequences.

Secondly, the effect on Bulgarian tax revenues and the economy is also questionable. Of course, VAT will be collected earlier on some lease contracts than at present. However, the effect of earlier collections will be reduced by input tax deduction if the lessees have the right to deduct the VAT. In addition, the amendment can shift the acquisition preferences of lessees who do not have a right to deduct VAT. They may, for example, go for a straight purchase with deferred payment, which may redirect business from lessors to other credit institutions. Alternatively, they may consider entering into operational leases instead of financial leases. We already saw that a few months after the change, lessors had started advertising operational lease products more actively. These potential economic changes could offend the principle of neutrality, whereby VAT law should not influence the way in which business is conducted.

However, on a positive note, we are pleased that the legislators’ original intention to apply the change to outstanding leasing contracts has been given up. Had that happened, it would have led to a one-off collection of VAT from lessors who would have been incapable of collecting the VAT from their clients at the same time. In effect, this retroactive taxation would have been a serious cash flow hit on a number of leasing businesses. Therefore, restricting the scope of the change only to lease contracts in force after 1 January 2014 is not only a relief for lessors, it maybe also save Bulgaria from having another CJEU case on finance leases! Questions, however, on the necessity of the change and its conformity with the neutrality principle remain open.
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Canada

Related-party research, development and design costs now dutiable?

In one of the most important customs cases in years\(^1\) (referred to in this article as *Skechers Canada*) the Canadian International Trade Tribunal (CITT) confirmed an aggressive interpretation by the Canada Border Services Agency (CBSA) concerning additions to the transaction value for intercompany payments made outside of the invoice amount or transfer price that relate to design and development costs allocated to the importer.

As part of a recent enforcement trend of the CBSA toward assessing customs duty on intercompany management or other fees not included in the transfer price, the CBSA determined that the total research and development (R&D) intercompany fees paid by the Canadian company were part of the value for duty allocated over the goods actually imported. In a potentially far-reaching decision, the CITT endorsed this decision for cases where the importer cannot demonstrate that the payments are unrelated to the goods.

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1. Skechers USA Canada Inc. v The President of the Canada Border Services Agency (2013), AP-2012-073 (CITT).
The Skechers Canada case

The taxpayer in Canada purchased footwear from its US affiliate and established a transfer price for goods based on the US affiliate's factory cost from the offshore manufacturer plus transportation, warehousing and an amount for profit. This price included the cost of "assists" relating to the molds and samples that the US affiliates provided to the manufacturers for the successful models subsequently imported, but it did not include the value of the design work performed in respect of the development of unsuccessful prototypes or models (approximately 45,000 of the 50,000 models under development never made it to the final stage), nor the costs for the general research and development expenses of the US affiliate (salaries and overhead of research, design and development staff). Therefore, the taxpayer also made payments for these costs to the US affiliate under a cost-sharing agreement (CSA).

The fees paid by the taxpayer under this agreement were a function of the volume of import purchases. They were calculated based on operating profit of the taxpayer pursuant to the terms of the CSA and thus varied with volumes of imports and sales. As noted, of the approximately 50,000 models under development, only 5,000 made it to the final cut, and of this only approximately 1,700 were imported to Canada. Accordingly, most of the payments for research and design and development under the CSA were not included in the transfer price.

The decision

Both parties to the dispute agreed that the Tribunal should use the "transaction value" customs valuation methodology (the adjusted transfer price). The issue concerned whether the payments for R&D under the CSA were "in respect of" the goods and therefore part of the "price paid or payable" pursuant to Subsections 45(1) and 48(4) of the act.

A basic provision of customs valuation is that the transaction value must include all payments made "in respect of" the goods. The taxpayer contended that the payments were for intangibles and not in respect of the goods as they were for developing the brand.

In a precedent-setting decision, the Tribunal held that all payments under a cost sharing agreement relating to research, development and design were dutiable because they were, in the Tribunal's words, "clearly in respect of the goods" given that the evidence, including oral testimony from the taxpayer's representative, disclosed that "the R&D payments most directly concern the footwear products themselves." There was one continuous process by which the research, design and development process flowed through the season to develop the footwear.

In a precedent-setting decision, the Tribunal held that all payments under the CSA relating to research, development and design were dutiable because they were, in the Tribunal's words, "clearly in respect of the goods" given that the evidence, including oral testimony from the taxpayer's representative, disclosed that "the R&D payments most directly concern the footwear products themselves." There was one continuous process by which the research, design and development process flowed through the season to develop the footwear.

In finding that all the research, development and design costs under consideration were not general payments unaffected by the volumes of imported goods and, therefore, within the meaning of the phrase "in respect of" in Subsection 45(1) of the act, the Tribunal followed its decision in Chaps Ralph Lauren. In that case, the Tribunal concluded that the phrase "in respect of the goods" meant that the payment must not be a general payment unaffected by the specific goods being imported. In the Tribunal's view, this requirement was met in Chaps Ralph Lauren since "the amount of the royalty payments [was] based on the net sales of the imported goods in Canada and [was], therefore, affected by the specific goods imported." In arriving at its decision, the CITT distinguished its decision in Simms Sigal, where it had held that:

2. Chaps Ralph Lauren, A Division of 1311384 Canada Inc. and Modes Alto-Regal, Inc. v. The Deputy Minister of National Revenue (1997), AP-94-212 and AP-94-213 (CITT).
“The Tribunal does not accept the proposition advanced by the Commissioner that all payments made by a purchaser to or for the benefit of a vendor are to be included in the transaction value. The definition of ‘price paid or payable’ provided in the Act makes clear that only those payments made in respect of the goods are included. Although the expression ‘in respect of’ is quite broad, the Tribunal is of the view that, given the context relating to the sale of goods for export, this does not cover the distribution fee paid to Anne Klein for exclusive distribution rights or services.”

Impact on supply chain planning

In arriving at its momentous decision in Skechers Canada, the CITT decided that all payments under the CSA relating to research, design and development expenses incurred by the US company and passed on to the Canadian affiliate as part of the CSA were payments “in respect of” the goods sold for export to Canada and therefore formed part of the “price paid or payable” as defined in the Customs Act. Accordingly, these amounts were dutiable under the basic transaction value provisions (Sections 47 and 48(4) of the act).

While the result would be no different in the case of nonrelated vendors — and is, perhaps, more obvious — it is of great import to related-party supply chains and is a wake-up call for many multinationals to take customs planning into account rather than just income tax or logistics planning. Further, it highlights the need to be aware of, or to seek advice from advisors experienced with, the latest case law or CBSA policy. This decision is part of a recent trend of audits and corresponding case law focusing on multiple-tier sales structures and off-invoice payment flows. Customs compliance and leading practices for planning need to be considered along with any other savings to achieve the best overall efficiency for the supply chain. This was no doubt an unexpected and expensive surprise for the taxpayer!

The decision also has a potential impact on the contentious and often overlooked issue of dutiable “assists” (i.e., goods or services that are provided to the supplier at nil or a reduced charge and therefore are not built into the price) even though the taxpayer tried to argue these provisions applied to reduce the amount subject to duty (and import GST interest).

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4. Customs Act, 1985, c. 1 (2nd Supplement.) ss. 45(1).
What the Skechers Canada decision does not impact

Significantly, the decision did not extend to advertising and marketing expenses paid under the CSA, or to certain administrative and support services paid under a management and services agreement. Royalties paid for certain intellectual property rights under a separate license agreement were also not considered to be dutiable. Further, the amounts were not paid for distribution rights, an important and useful distinction. The Tribunal distinguished and confirmed its decision in the *Simms Sigal* case, where it held that payments for distribution rights were not made in respect of imported goods as Simms Sigal did not provide sketches or designs or pay for any R&D.

Lessons learned?

First and foremost, a supply chain structure must be considered very carefully when importing goods into Canada, particularly through a supply chain involving affiliated parties. Often a direct sale from the manufacturer to the importer may have customs planning advantages. Where there are purchases from a related party who sources the goods abroad, it is important to ensure that the transfer price is acceptable for customs valuation purposes and to confirm whether any adjustments are required for other payments, such as research and development costs and royalties. In a direct sale, “assists” must also be considered.

This case has also relevance as to what can constitute “assists” under subparagraph 48(5)(a)(iii) of the act. While not in issue directly in this case, since the importer did not provide goods or services to its US affiliate or the manufacturers (rather the CSA payments were made so the US affiliate could provide the design and development assistance to the maker), clearly the Tribunal’s thinking was that this provision can be broad enough to encompass goods or services provided to the supplier free or at a reduced price even where the prototypes are not all purchased for import or are used for aborted designs. (It has been the position of the CBSA that the value of all assists should be apportioned over the goods actually produced and imported.)

While this case is the subject of an appeal, it is also important to remember the old adage – be careful what you ask for! In this case, the CBSA initially assessed only a portion of the R&D expenses. While it is not clear from the facts, this amount appeared to be for the R&D in relation to the products imported into Canada. However, following an administrative appeal by the taxpayer, CBSA reassessed to make a further redetermination including the totality of the R&D payments.

Finally, it is noted that the onus is on the importer to prove that any payments made are not in respect of the goods under the act. This point is often overlooked. In this case, it was crucial as the Tribunal made its finding on the basis that the taxpayer did not discharge this onus. It is important to keep the importer’s onus of proof in mind when undertaking any customs duty planning and also when deciding to make any appeal against a determination.
On 1 January 2014, the Mexican tax authorities finally published regulations related to attaining the certification required to benefit from a VAT credit. As of 1 January 2015, the regulations apply to goods destined for several customs regimes, including the temporary importation of goods for the elaboration, transformation or repair in an IMMEX or exports programs.


2. Program authorized by the Mexican Ministry of Economy, under the Decree for the Promotion of the Manufacturing, Maquiladora, and Exportations Services Industries.
The recently enacted amendments to the Mexican VAT law include several new provisions that impose VAT upon the temporary importation of goods for the execution of activities authorized under an IMMEX program.

Background

Until 31 December 2014, the temporary importation of goods into Mexico for the execution of activities authorized in IMMEX programs is expressly exempt for VAT purposes.

However, as we have reported previously in this publication3, that exemption is due to end. Directly motivated by, among other things, the recommendations contained in the 2013 OECD Base Erosion and Profit Sharing (BEPS) Report4 (which tend toward the general elimination of exemption regimes and specifically mention the IMMEX regime), the tax reform proposal initially submitted by the Federal Executive to the Congress of the Union contemplated several measures. They included substantially (but not formally) eliminating the IMMEX regime, as the reform deprived it of its tax and customs benefits.

More precisely, the numerous proposals were inclined to increase tax collection through the gradual elimination of exemption regimes, including the abolition of the aforementioned exemption. At the same time, it granted a refund for the VAT paid on the temporary importation of goods until their permanent exportation. This initial position, unparalleled throughout worldwide customs systems, which contemplate the temporary importation mechanism, caused widespread concern in the Mexican manufacturing and exports sector. This was mainly due to the significant cash flow inconveniences for companies, derived from the time gap between paying the VAT and receiving the refund.

During the tax reform discussion process, the lobbying efforts of different groups in the manufacturing and exports sector resulted in the announcement of a compromise with the tax authorities. The tax authorities agreed not only to define a certification mechanism for companies affected by the new VAT on temporary imports, which would neutralize its adverse cash flow effects, but also to suspend the elimination of this exemption until one year after the publication of the regulations for the certification.

VAT on the temporary importation of goods in 2014

The recently enacted amendments to the Mexican VAT law include several new provisions that impose VAT upon the temporary importation of goods for the execution of activities authorized under an IMMEX program. However, the transitional provisions of this law expressly suspend the entry into force of these specific amendments until one year after the certification rules required to obtain credit for the VAT paid on temporary importations are publicized in the Federal Official Gazette.

Therefore, given that the tax authorities issued these rules on 1 January 2014 to be effective 1 January 2015, the temporary importation of goods for the execution of activities authorized under an IMMEX program will bear VAT at the general 16% rate.

It is worth stressing, that as of 1 January 2015, with the entry into force of the articles defined in the transitional provisions, companies paying VAT for the temporary importation of goods covered by the provision will be authorized to credit or compensate the VAT paid, or request a refund, after the temporarily imported goods are exported from Mexico.

Nonetheless, Article 28-A of the Mexican VAT law expressly contemplates the possibility that taxpayers may apply tax credit of 100% of the VAT paid upon the temporary importation of goods, to the extent that they previously obtain a certification from the tax authorities in accordance with the rules. Alternatively, the article authorizes the temporary importation of qualifying goods without the payment of VAT, provided that the taxpayer guarantees the tax liability by providing a bond through an authorized financial institution.

VAT and excise tax certification

In general terms, the rules define three types of VAT and excise tax certification (the Certification), specifically A, AA and AAA. In addition, the rules establish the mandatory requirements, as well as the permanent obligations, required to obtain the benefits of each type, the terms and formalities of the relevant procedure, and the causes of cancellation of the Certification.

General requirements applicable to the three certificate types

To corroborate that the Certification applicant is generally compliant with the corresponding tax and customs obligations, Rule 5.2.13 defines the general requirements that must be fulfilled under the three certificate types as follows:

1. The taxpayer must file an application (the Application) for the Certification through the Single Window System (VUCEM) of the tax authorities.
2. It must maintain an automated inventory control system for customs purposes.
3. The taxpayer, its stockholders, legal representatives and the members of its board of directors must obtain a positive tax compliance opinion from the tax authorities, issued no more than 30 days before the submission of the Application.
4. The taxpayer must have valid certificates of digital seals for electronic invoices that have not been deemed as invalid during the 12 months prior to the submission of the Application.
5. The taxpayer must provide records of all of its employees enrolled with the Social Security Institute (IMSS) and supporting documentation of the payment of payroll contributions for 10 employees.
6. The taxpayer must provide documentation that demonstrates its investment in Mexico.
7. The taxpayer must indicate the name and address of the foreign customers and suppliers with which it has carried out foreign trade activities during the previous year.
8. The taxpayer must grant access to the personnel of the Customs Audit Administration (AGACE) as required for the verification of the taxpayer’s compliance with the customs parameters.

Certification under type A

Furthermore, this rule establishes additional requirements that must be met by IMMEX companies in order to obtain the Certification under type A:

1. The company must have a valid IMMEX program.
2. It must have a registry of all addresses linked to the IMMEX program with the tax authorities.
3. It must have the infrastructure required to perform the respective IMMEX program operation.
4. It must demonstrate that the value of goods transformed and exported during the last 12 months represents at least 60% of the value of its importations.
5. It must demonstrate the right to use the facilities where the productive processes are carried out.
6. It must provide a description of the activities related to the productive processes.
7. It must demonstrate that the taxpayer has a maquila agreement, a sales agreement or purchase orders that justify the continuance of the export project.

IMMEX companies that fulfill these requirements should be eligible for the Certification under type A.

Certification under type AA

Rule 5.2.13 defines the requirements that should be met in order to obtain the Certification under type AA as follows:

1. At least 40% of the value of the operations performed in Mexico by the taxpayer in the preceding year should have been performed with suppliers that, as of the date of submission of the Application, have a positive tax compliance opinion from the tax authorities, have valid certificates of digital seals for electronic invoices, and are not included in the list of noncompliant taxpayers issued by the tax authorities.
2. The taxpayer has operated for the previous five years under the regime for which the certification is requested, the taxpayer has had an average of 1,000 employees registered with the IMSS during the previous tax year, or it has machinery and equipment worth more than 50 million Mexican pesos (approximately US$4 million).
3. The taxpayer has not had a tax assessment determined by the tax authorities during the previous 12 months, has requested the authorization for the deferred payment of omitted contributions in a term that shall not exceed 12 months, or has paid the corresponding omitted contributions.
4. The taxpayer has not had VAT refund denials in the previous 12 months.

As of 1 January 2015, companies paying VAT for the temporary importation of goods covered by the provision will be authorized to credit or compensate the VAT paid, or request a refund, after the temporarily imported goods are exported from Mexico.
Certification under type AAA

Similarly, in order to obtain the Certification under type AAA, the rule defines the following requirements:

1. At least 70% of the value of the operations performed in Mexico by the taxpayer in the preceding year should have been performed with suppliers that, as of the date of submission of the Application, have a positive tax compliance opinion from the tax authorities, have valid certificates of digital seals for electronic invoices and are not included in the list of noncompliant taxpayers issued by the tax authorities.

2. The taxpayer has operated for the previous seven years under the regime for which the certification is requested, the taxpayer has had an average of 2,500 employees registered with the IMSS during the previous tax year, or its machinery and equipment is worth more than 100 million Mexican pesos (approximately US$8 million).

3. The taxpayer has not had a tax assessment determined by the tax authorities during the previous 24 months, has requested the authorization for the deferred payment of omitted contributions in a term that shall not exceed 12 months, or has paid the corresponding omitted contributions.

4. The taxpayer has not had VAT refund denials in the previous 12 months.

Procedure and renovation of the Application

According to Rule 5.2.13, after the submission of the Application, the customs authorities have 40 days in which to conclude the corresponding procedure with a resolution. If any omission or irregularity is detected, the customs authorities may electronically require the submission of the pending information or documentation within 15 days. Further, if the customs authorities do not issue a resolution within the 40-day term, the Application will be deemed to be denied.

In addition, if as a result of the inspection the customs authorities determine that the taxpayer lacks the controls required to perform its productive processes, the taxpayer will be disqualified from filing a new Application for the following six months.

With regards to the renewal of the Certification, Rule 5.2.13 authorizes its renovation, to the extent that the corresponding application is filed, within the 30 days prior to the end of its validity, and the taxpayer demonstrates that it still meets the applicable requirements. The customs authorities have 20 days to issue a resolution in response to the renovation request. Notably, if a resolution is not issued within this term, the Certification shall be deemed to be renewed.

It is worth noting that the rules expressly mention that a manual with the specific instructions for applying for the Certification will be issued within 40 days after the publication of the rules.

Finally, companies that intend to apply for the Certification during 2014 must observe the following calendar, based on their tax address and the relevant of the Regional Administration of Foreign Trade Affairs (ARACE).

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<tr>
<th>ARACE</th>
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<td>Certified companies</td>
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<td>3 June-3 July</td>
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<td>Center North</td>
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<td>West and South</td>
<td>22 September-22 October</td>
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Benefits of Modality A

Pursuant to Rule 5.2.14, a taxpayer with a Certification under modality A will have the following benefits:

1. Claiming a tax credit for its operations related to customs regimes for the elaboration, transformation and repair in IMMEX or exportation programs, among others

2. Obtaining VAT refunds less than days 20 after the submission of the corresponding application

3. Being given a Certification valid for one year
Benefits of Modality AA

Further, Rule 5.2.14 confers the following benefits to companies with a Certification under type AA:

1. They get a tax credit for their operations related to customs regimes for the elaboration, transformation and repair in IMMEX or exportation programs, among others.
2. They obtain VAT refunds in less than 15 days after the submission of the corresponding application.
3. They can observe a grace period of 30 days for the self-correction of irregularities they identify with no penalty.
4. The tax authorities issue an invitation for them, rather than a formal requirement, for the correction of any presumptive omission of customs taxes.
5. If the customs authorities identify any cause for the suspension of the taxpayer’s importers and exporters registry, the suspension procedure shall be observed, regardless of the cause of suspension.
6. They are given a Certification valid for two years that is automatically renewable.

Benefits of Modality AAA

Finally, Rule 5.2.14 grants the following benefits to companies with a Certification under type AAA.

1. They get a tax credit for their operations related to customs regimes for the elaboration, transformation and repair in IMMEX or exportation programs, among others.
2. They obtain VAT refunds less than 10 days after the submission of the corresponding application.
3. They can observe a grace period of 60 days for the self-correction of irregularities they identify with no penalty.
4. The tax authorities issue an invitation for them, rather than a formal requirement, for the correction of any presumptive omission of customs taxes.
5. If the customs authorities identify any cause for the suspension of the taxpayer’s importers and exporters registry, the suspension procedure shall be observed, regardless of the cause of suspension.
6. Filing monthly consolidated customs declarations is possible.
7. Demonstrating that they comply with the regular automated inventory control system requirement is possible if their inventory control reflects the destination, depletion and balances of raw materials.
8. Performing the customs clearance of goods for their temporary importation is possible without declaring or transmitting the serial numbers in the customs declaration, or the applicable document, as long as the taxpayer holds such information in an updated inventory control system.
9. Conducting the customs clearance for the exportation at the taxpayer’s address is possible, to the extent that certain guidelines defined by the customs authorities are fulfilled.
10. They are given a Certification valid for three years that is automatically renewable.

A. Permanent obligations

Finally, Rule 5.2.16 establishes several obligations that certified companies must permanently fulfill under the three types of certification. Among other things, they include the following conditions: the taxpayer must comply with the requirements of its type of certification and allow the customs authorities to physically inspect its facilities as required.

1. The taxpayer must notify the customs authorities, within five days, of any changes in its name, address, legal representative or shareholding composition.
2. The taxpayer must update the data in the Application within 30 days in the case of any changes related to its transportation companies, its bonded warehouses, and its Mexican and foreign clients and suppliers.
3. The taxpayer must perform all foreign trade operations with transportation companies that are registered with a Transporters Harmonized Alphanumeric Code.
4. IMMEX companies that have Certification must electronically record the registry of companies with which they carry out virtual operations, as well as provide the tax ID (RFC) of the companies with which they perform sub-maquila processes.
5. The taxpayer must comply with the payment of payroll taxes, through the respective online payment system.

Causes of cancellation

Finally, Rule 5.2.17 defines several causes of cancellation of the Certification, which include:

1. Demonstrated failure by the taxpayer to comply with any condition required to obtain the Certification
2. Denying access to the customs authorities for inspecting the taxpayer’s facilities

It remains uncertain how practical it will be to apply several provisions contained in the rules. It seems likely that modifications or clarifications to the current rules will be issued.
3. A demonstrated cause for the suspension of the taxpayer’s importers and exporters registry
4. Failure to demonstrate, during any inspection by the customs authorities, that the taxpayer has the infrastructure required to perform its productive process
5. Noncompliance by the taxpayer with any of the aforementioned permanent obligations
6. Failure by the taxpayer to demonstrate the exportation, transfer or destination to another regime of its temporary imports of goods
7. Keeping goods temporarily imported under an IMMEX program at any address other than those specified in the taxpayer’s program
8. Failure by the taxpayer to demonstrate the legal permanence in Mexico of foreign trade goods worth more than 100,000 pesos (approximately US$8,000)
9. Noncompliance by the taxpayer with the terms defined by the tax authorities for the deferred payment of tax assessments
10. Commencement of a procedure for the cancellation of the taxpayer’s authorization to operate in its relevant customs regime.

In these circumstances, the customs authorities will notify the taxpayer electronically that the cancellation procedure has been activated, indicate the corresponding motivation, decree the suspension of the effects of the Certification, and grant the taxpayer a 10-day term for the submission of its arguments and the relevant proof. The Mexican customs authorities will have four months to issue the corresponding resolution; if the resolution is negative, it will disqualify the taxpayer from Certification for the following 24 months.

**Final remarks**

It remains uncertain how practical it will be to apply several provisions contained in the rules. This is perhaps the result of the need to issue them promptly in order to begin computing the one-year suspension of VAT’s entry into force on the temporary importations of goods for executing activities authorized under an IMMEX program. Given this, it seems likely that modifications or clarifications to the current rules will be issued; in fact, this has already been confirmed, with the express promise in the rules of a subsequent manual with instructions for applying for the Certification.
A large problem for the VAT system in Russia and for entrepreneurs operating in the country is the large number of “mala fide” taxpayers in the supply chain who are engaged in missing trader fraud involving VAT and tax evasion. In this article we outline the current situation in Russia concerning mala fide or “missing trader” taxpayers and risks for bona fide companies. We also provide some guidance for legitimate companies to help mitigate the risks associated with dealing with missing traders.
Missing traders

Missing-trader fraud is a growing issue in Russia, as it has been in other parts of the world, including the EU. According to the Russian Central Bank, more than 250,000 companies did not pay any taxes in 2010, but together they still generated more than US$130 billion in turnover. In addition, experts estimated that more than half of the 4.5 million registered entities in Russia show characteristics that are typical for “missing traders.”

These statistics are worrying and indicate not only a widespread level of evasion, but also the increased likelihood that bona fide companies may unwittingly encounter these traders and enter into contracts with them in the course of doing business.

Missing traders are companies that are established without the goal of performing real economic activities. They are often registered at an accommodation address (i.e., many legal entities registered at one location), do not have an office or real employees and, most importantly, they do not fulfill their tax obligations, or do so only to a limited extent. Generally, missing traders act as intermediaries who provide goods and services only on paper. While they charge VAT with respect to these goods and services, they do not pay any VAT and profits tax to the Russian budget.

Currently, Russia’s budgetary income is declining as the country’s economy cools down. As a result, the tax authorities are focusing more and more on combating missing traders and on retrieving tax revenues lost due to their activities. However, missing traders are often very hard to catch, since they are short-lived companies and, in almost all cases, the money is long gone before the tax authorities manage to identify them.

The bona fide companies dealing with them, on the other hand, are much easier targets. As a result, the Russian tax authorities have shifted the responsibility for checking and controlling potential mala fide subcontractors onto bona fide contractors. This policy has proven to be successful. The Russian tax authorities have developed a special approach, and they often work with the police in these matters. More and more, the Russian tax authorities are successfully raising assessments on bona fide companies for tax related to contracts undertaken with missing traders. To stand a chance of defending themselves against these assessments in court, legitimate companies need to adopt a well-developed tax due diligence framework.

Risks for bona fide companies

So what are the risks that bona fide companies face if they are caught up, albeit unwittingly, in supply chains involving fraudulent traders?

The first thing to consider is the concept “unjustified tax benefit,” which is well developed in Russian jurisprudence. Generally, Ruling No. 53 of the Plenum of the Higher Arbitration Court, dated 12 October 2006, establishes the criteria and guidelines for recognizing a tax benefit as “unjustified.” In particular, the following indicators could be used by the tax authorities:

- The technical inability of a subcontractor to perform the activities in the contract, due to a lack of material resources or a lack of personnel
- The incorporation of a supplier shortly before the activities took place
- An affiliation of the parties involved in the contract
- The “one-off” nature of the operation

Using these types of criteria, the Russian tax authorities have successfully disputed the deductibility of expenses for profits tax purposes and the recovery of input VAT for amounts paid by bona fide companies to missing traders. Tax assessments levied in these circumstances may cover up to three calendar years preceding the year when the tax audit started. Together with penalties and late payment interest, the sum charged could be up to 50% to 55% of the value of purchased goods or services.

The legislators are also currently discussing the possibility of including new provisions in the Russian Tax Code that will provide a legal basis for a taxpayer to lose the right to recover VAT or deduct expenses if both:

- The taxpayer’s subcontractor is a missing trader.
- The taxpayer did not properly check the background of its subcontractor.

If this plan is realized, it is likely to be easier for the tax authorities in the future to assess for deducted VAT and profits tax from bona fide taxpayers who have entered into contracts with missing traders.

What can be done?

Every company in Russia is expected to evaluate potential suppliers before entering into any business relationship with them. The Russian court practice and official clarifications give guidance on what measures contractors should take when hiring subcontractors. These measures include, among other things: requesting identification documents from potential subcontractors, carrying out independent background research and sending a request to the tax authorities to clarify whether the subcontractor complies with its tax obligations.

Every company in Russia is expected to evaluate potential suppliers before entering into any business relationship with them.

There are several sources of information publicly available online that can provide valuable background information on a potential subcontractor, such as:

- Information on the state registration of the subcontractor
- Information on whether the subcontractor is registered at an accommodation address

Every taxpayer should have an internal policy and internal procedures in place to check the background and reliability of new and existing subcontractors. The existence of such policy in itself may significantly reduce the chance of entering into contracts with missing traders; furthermore, it may offer a strong argument in court that the taxpayer has acted with due diligence in the process of selecting its subcontractors.

Conclusions

Careful management of the process of contracting with Russian suppliers is important for doing business effectively in Russia. An ill-considered choice of subcontractors may result in negative tax consequences and tax losses. Therefore, a well-developed tax due diligence framework is needed by all bona fide companies operating in Russia. The framework will not only help them to avoid doing business with mala fide suppliers in the first place, but it may also help to protect them against claims by the tax authorities if a missing trader should slip through the net.
South Africa

SARS looking for improved compliance and tax collection via data analytics

For a number of years, the South African Revenue Service (SARS) has been undertaking a modernization program. In connection with this program, and the authority’s more recent 2013-2014 Strategic Plan, SARS is embarking on becoming a world-leading revenue authority, making use of increasingly sophisticated systems-based audits and data analytics. In this article we look at Form IT14SD, which SARS is using to reconcile taxpayer data across a wide range of direct and indirect taxes. This new approach to data extraction has far-reaching implications for taxpayers in South Africa who will need to understand not only the new form but also how they can prepare to meet any challenges to their data.

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SARS is embarking on becoming a world-leading revenue authority, making use of increasingly sophisticated systems-based audits and data analytics.

Extracting taxpayers’ data
SARS has already developed robust analytical capabilities. For example, the authority is already performing tax audits by examining companies’ general ledger system data, retrieved using a direct data connection.

As far back as 2011, in line with its modernization initiatives, SARS introduced an additional process to the annual corporate income tax return submission and assessment process (VAT201 declaration). This additional process is referred to by SARS as the “Verification of Income Tax Return” process. It allows SARS to request vendor taxpayer to review and, if necessary, revise a VAT201 declaration or submit supporting documents in cases where SARS has a query about the declaration.

Further to this process, SARS has now implemented a new return to be completed by companies, called the IT14 Supplementary Declaration (IT14SD). SARS may issue the new IT14SD form to companies and close corporations after their tax returns have been filed. Using the new form, companies and close corporations must reconcile their income tax, VAT, employees’ taxes (PAYE/UIF/SDL) and customs declarations. SARS believes this far-reaching provision meets its mandate to collect all revenues due, ensure optimal compliance and improve the effectiveness of audits.

Form IT14SD process
When an annual corporate income tax return is submitted, SARS assesses it and asks the taxpayer to review the return submitted against the assessment issued. In the event that there are any discrepancies, the taxpayer is required to amend its return accordingly. If there are no discrepancies, the taxpayer will then be required to complete and submit an IT14SD return.

Essentially the purpose of this return is to reconcile a taxpayer’s whole tax data by reconciling its VAT PAYE and customs duties information back to the corporate income tax return it has submitted. All unreconciled differences must be explained. All taxpayers will be given 21 calendar days to complete and submit the return. If SARS does not agree with the explanations provided, it may allocate the return for an audit.

The purpose of Form IT14SD
It appears that SARS will be using this process as a form of “self-assessment.” This means that SARS will act based on the information populated on the IT14SD submitted. Should there be any unexplained (or insufficiently explained) unreconciled differences, the initial corporate income tax return submitted will likely be audited.

What does SARS want taxpayers to reconcile?
• **PAYE:** The taxpayer must reconcile its employee tax declarations (EMP201 and EMP501) to its staff costs as stated and disclosed on the IT14 tax return.
• **VAT:** The taxpayer must reconcile its total amount for VAT-able supplies (that is, standard-rated, zero-rated and exempt supplies) according to its VAT 201 declarations to the figure for sales or turnover as stated and disclosed on the IT14 tax return. In addition, the total amount of input VAT related to normal supplies as well as related to acquisitions must be reconciled to the cost-of-sales figure as stated and disclosed on the IT14 tax return.
• **Customs:** The value of exported goods recorded on the taxpayer’s customs declarations (SAD 500 declarations) and/or voucher of correction (SAD504 or SAD554 declarations) must be reconciled to the amount included in exported goods in the sales or turnover figure on the IT14 tax return.
• In addition, the value of imported goods according to the customs declarations (SAD 500) and/or voucher of correction (SAD504 or SAD554 declarations) must be reconciled to figure for exported goods included in cost of sales.
Some practical challenges in reconciling Form IT14SD values

To date, most of the challenges that our clients have experienced in completing their IT14SDs relate to customs and VAT. These challenges include:

- The customs part of the IT14SD requires a taxpayer to disclose the total value of imported goods according to its customs declarations. Generally, companies do not have this information, as, until now, there was no reason for them to capture it. In many cases, the information is actually held by third parties. To respond to this need, companies will have to capture this information manually, adopt new internal processes or obtain the amount from their clearing agent(s), if possible.

- If a company is in a position to obtain the total value of imported goods, this amount should be reconciled to the amount for imported goods included in cost of sales and total goods imported as recorded on the VAT return. However, doing this can be a significant challenge, because companies cannot generally identify from their cost of sales what part relates to local purchases and what part to foreign purchases. Also, the value that has to be captured from the VAT return is the value declared in block 15A of the declaration (VAT on non-capital imports). This figure is the actual VAT amount paid and not the value of the imported goods. Companies will have to recalculate the value of imported goods on an item-by-item basis.

- The goods-receipt/invoice-receipt (GR/IR) clearing account is a bookkeeping device used within enterprise resource planning (ERP) systems that can be used when goods arrive before the invoice is generated or when an invoice arrives before the goods are delivered. In the normal course of business, discrepancies and timing differences often exist between the receipt of goods and the quantity invoiced for a purchase order. However, where these discrepancies exist, they may require taxpayers to carry out a highly manual reconciliation effort for IT14SD purposes.

Potential taxpayer exposure

Taxpayers who submit IT14SD returns with unexplained or insufficiently explained unreconciled differences may be exposed to an audit by SARS. It should be noted that a favorable result from any appeal is not guaranteed for the following reasons:

- The taxpayer would have signed a declaration that the information and disclosures on the IT14 return are true and correct.
- When the IT14SD is issued, SARS provides the taxpayer with another opportunity to rectify the IT14 tax return. By not making any amendments, this is likely to be seen as a second declaration made by the taxpayer that the information disclosed on the IT14 return is true and correct.
- The SARS guide to completing the IT14SD informs taxpayers that: “The IT14SD is a legal declaration to SARS and by signing it the representative of the company agrees that the reconciled information is accurate.” The guide goes on to mention that “The representative of the company is obliged to ensure that a full and accurate disclosure is made of all relevant information.” Furthermore, “Misrepresentation, neglect or omission to submit the IT 14SD or supplying false information may result in prosecution.” Therefore, by populating the IT14SD and submitting the same unreconciled differences, this could be seen as a declaration that the information furnished and disclosed is true and correct.
EY has developed a framework to help South African corporate taxpayers complete and submit accurate IT14SD returns in a short amount of time. This framework uses a three-phased approach:

Phase 1
- Using the taxpayer’s information in its current state, we compile a pro forma IT14SD and highlight standard reconciling differences (industry-specific) as well as quantify the unreconciled differences.
- We also prepare a high-level risk assessment based on the information provided.
- The taxpayer can assess its position and decide whether it is comfortable submitting its Form IT14SD and explaining the unreconciled differences based on the pro forma.
- If the taxpayer is not comfortable with the results of Phase 1, further analysis and steps can be taken before submitting Form IT14SD.

Phase 2
- Based on the results of Phase 1, we analyze the detailed information provided to explain the unreconciled differences.
- We then provide a completed IT14SD return for the taxpayer’s review and sign-off.
- We then update our risk assessment based on the detailed work performed.

Phase 3
- We analyze the root causes of the unreconciled differences.
- We perform a gap analysis based on current systems and processes compared with leading practices.
- We provide recommendations and suggested actions for sustainable future improvements.
In common with many other countries, South Africa is grappling with the issue of how to apply VAT to new ways of doing business, facilitated by online trading and the internet. Effective 1 June 2014, South Africa will apply VAT to supplies of electronic services (e-services) made by foreign suppliers to South African customers. In this article, we consider the scope of new rules and some of the issues associated with them.
Effective 1 June 2014, South Africa will apply VAT to supplies of electronic services (e-services) made by foreign suppliers to South African customers.

The scope of South African VAT

The South African VAT Act does not contain any “place of supply rules” – that is, the VAT rules that in other VAT systems determine the jurisdiction that may tax a specific transaction. Further, the application of the South African VAT Act is not limited to South African residents, and it also does not make a distinction between business-to-consumer transactions and business-to-business transactions.

Taken together, these facts mean that any person’s activities may fall into the South African VAT net. However, despite the potentially limitless scope of the VAT law, the VAT Act was recently amended to specifically include foreign suppliers of “electronic services” as subject to South African VAT.

Why was the VAT law changed?

The change to the VAT Act came about as a result of lobbying from local suppliers of electronic books. They argued that they were in an uncompetitive position compared with foreign suppliers, as the foreign suppliers were not required to register as VAT vendors and account for VAT on their supplies of e-books to South African recipients. In other words, by selling these digital products from a wholly foreign location, nonresident vendors could sell e-books exclusive of any VAT, whereas South African suppliers of these products had to charge VAT at 14% on these sales, seemingly putting them at a disadvantage in the market.

The South African VAT Act does contain a provision that VAT must be accounted for on imported services insofar as the recipient does not use the service for taxable output VAT. Essentially this is a reverse-charge mechanism focused on consumers that do not have a full right to deduct input VAT on services acquired from nonresidents. Under this provision, the recipient of the service is obliged to account for VAT to the extent that the service was acquired for a purpose other than for making taxable supplies. This provision even applies, at least in theory, to purchases made by private consumers. For example, a South African consumer who buys an e-book from abroad should voluntarily request a specific form and declare and account for VAT on the purchase. The net effect of this means that the VAT difference of purchasing a foreign service compared with purchasing it from a local supplier should, in theory, be nil.

However, the problem is that imposing import VAT on purchases made by private consumers in these circumstances was found to be impractical, and compliance levels were almost nonexistent. As a result, suppliers of electronic services are now specifically included in the South African VAT net.

Registration liability

In South Africa, anyone who carries on an enterprise and exceeds a certain turnover threshold must apply for VAT registration. An “enterprise” is basically any business activity performed in the Republic, potentially resulting in a very wide scope (there are multiple additions and exceptions to this rule).

The amended definition of “enterprise” now also includes an “electronic services” provision that any person is carrying on an “enterprise” for South African VAT purposes if it either:

- Supplies “electronic services” from a place outside of South Africa to a South African resident
- Involves a payment for the electronic service that is made through a South African bank

Therefore, a foreign supplier of electronic services that makes taxable supplies which exceeds ZAR 50,000 after 1 June 2014 will be required to register and account for VAT. The standard VAT rate will apply to these sales, which is currently 14%.

It should be noted that this turnover threshold is not subject to any time limitation. Moreover, a South African resident can be a private consumer, but it can also be any business or other entity in South Africa, including a subsidiary or sister company. This application of VAT registration for supplies made business-to-business (B2B) as well as business-to-consumer (B2C) is wider than the provision in jurisdictions such as the EU, and it may catch unwary foreign suppliers that provide only B2B services. In this regard, the South African authorities have indicated that South Africa considers itself to be a modern VAT system, and they will not enter into some of the discussions we have seen in the past (for example, in the EU) on limiting the scope of VAT related to digital goods and services.

Electronic services

So the crucial question now is, what types of services qualify as “electronic services” for these purposes?

Initially, it was indicated that the rules would aim to capture games, e-books, music and similar electronic products in the South African VAT net.

However, in January 2014, the tax authorities published a draft regulation that captured almost everything in the VAT net, including items such as software, information system services and even, arguably, telecommunications. This draft provoked many adverse comments from businesses, academics and consultancy firms, which were invited to share their thoughts on the new rules. The main concerns expressed in the consultation process were that the
new rules would require many foreign headquarters and shared service centers to register for VAT in South Africa when making intercompany charges to their subsidiaries. Moreover, the rules would not bring any additional revenue to the authorities on such B2B transactions, since the subsidiaries would deduct the VAT either in full or in the same way as for imported services. The South African authorities responded positively to this comment, resulting in them applying a much more limited scope to the regulation.

In the final regulation released at the end of March 2014, electronic services are defined as:

- Educational services (educational services only qualify as e-services if supplied by a person that is not regulated by an educational authority in the foreign country)
- Games and games of chance
- Internet-based auction services
- The supply of e-books, audio visual content, still images and music
- Subscription services to any blog, journal, magazine, newspaper, games, internet-based auction service, periodical, publication, social networking service, webcast, webinar, web site, web application and web series

As a result of the change, in practice, most of the electronic services covered by the new rules are services that are more commonly supplied B2C rather than B2B. However, as we said earlier, there is no distinction between B2B and B2C supplies in South Africa's modern VAT system. If the services listed are supplied B2B, the foreign supplier still has a VAT registration obligation. Therefore, we recommend that all businesses with customers in South Africa carefully review whether they render any of the above services (or are paid for out of South African bank accounts).

Further, it is worth noting that if a mixed supply contains various elements and even one of them is an electronic service, the whole service will be caught in the South African VAT net. For example, subscriptions services for websites or web applications, as well as for educational services, may be elements that are included in intercompany head-office charges.

For the obvious suppliers of electronic services that are clearly caught by the new rules (i.e., e-learning, e-auctions and e-games), we recommend that they take action as soon as possible to not only register but also ensure that their systems are ready to process the South African requirements after 1 June 2014.

Finally, we would point out that the definition of what is an “electronic service” is laid down in a regulation and can easily be changed, although we would not expect this to happen at short notice.

**Registration procedure**

Another positive outcome of the consultation process is that the registration process for foreign suppliers of electronic services has been simplified. In particular, the entire process can be completed online.

To register for VAT, a supplier of electronic services must submit its application form together with scanned copies of supporting documentation. The registration for providing e-services may exist separately from any registration the company already has (although a supplier may also decide to use its existing registration).

Contrary to a normal foreign VAT registration, the supplier is not required to appoint a VAT representative in South Africa or open a local South African bank account. However, the applicant is required to provide contact details of a local representative for receiving information and correspondence.

Registration is mandatory from the end of the month when the threshold is exceeded (starting 1 June 2014). However, if a supplier estimates that it will exceed the threshold, it may register for VAT straight away at the specific office in Alberton that deals with electronic services. The registration application is generally processed within a few working days.

**Other VAT compliance requirements**

Other issues that foreign companies should consider as a result of being registered for VAT in South Africa include compliance with the country’s VAT invoice requirements, including currency requirements; how charging VAT affects pricing; the effect on the company’s position with respect to other taxes; and recordkeeping. Each of these issues is likely to depend on a company’s individual circumstances; therefore, companies should seek specific professional guidance on how they will be affected and on the actions they need to take. However, we can make some general observations:

- **Invoicing:** the VAT invoicing requirements under the new law are somewhat simplified, but taxpayers are obligated to issue an invoice. We would recommend putting the words “tax invoice” on the document issued to customers and ensuring that it clearly indicates that it is a South African invoice (e.g., in the invoice number add “SA”), although the invoice does not need its own numeric sequence. However, although simplified invoices are permitted, they may not satisfy the requirements to support deduction of input VAT by the customer. If a taxpayer supplies customers that may want to deduct the VAT, it may be prudent to adhere to all the full tax invoicing requirements under the South African law.
- **The VAT amount on the invoice:** the VAT charged must always be shown in South African rand, calculated using the daily exchange rate. Suppliers may use...
The potential scope of the new rules is fairly wide, and there are bound to be gray areas. But one piece of advice is clear: when in doubt, get a ruling!

exchange rates published by Bloomberg or the European Central Bank. If invoices are issued without any South African rand amount, a second document can be submitted in which the correct South African rand VAT amount is mentioned. However, it should be noted that this exchange rate requirement was still in draft at the time of writing this article, so detailed guidance should be sought on the current position before issuing invoices.

- Pricing (for example, on a website): it does not have to include the South African VAT chargeable as long as the site mentions that South African VAT may be charged if it is due.

- Permanent establishment risk: there is no indication that having a VAT registration for electronic services would have any impact on the supplier’s direct tax position or on its permanent establishment risk. However, this is a separate analysis that any company doing business in South Africa should undertake in any case.

- Recordkeeping: in principle, all records must be kept in South Africa. However, it is possible to get an approval to keep records abroad. This request can be filed together with the VAT registration, and we strongly recommend that foreign suppliers consider requesting this facility.

Rulings

The potential scope of the new rules is fairly wide, and there are bound to be gray areas. But one piece of advice is clear: when in doubt, get a ruling! The South African tax authorities have clearly articulated that if a supplier is in doubt about, for example, whether its services fall within the scope of the new rules, it should reach out to them to ask for a ruling. Obtaining a tax ruling in South Africa is a fairly straightforward process, and local advisors can help foreign companies draft the request and discuss it with the authorities, if necessary.

Conclusions

Effective 1 June 2014, suppliers of electronic services whose sales to South African residents exceed the turnover threshold are obliged to register for VAT in South Africa and charge South African VAT on their supplies. Any supplier of electronic services caught by the rules that does not apply for registration is guilty of an offense and is subject to a fine or imprisonment for a period not exceeding two years. In addition, the supplier will be liable for further noncompliance penalties, interest and understatement penalties on the supply of electronic services.

Given the consequences of noncompliance, companies that supply electronic services into South Africa should take action as soon as possible, even if they are not certain whether they are caught by the new rules. As a first step, given the broad definition of electronic services, companies that supply digital services of all types should analyze the exact scope of their services to determine whether they will have a possible VAT registration liability, and, if there is any doubt on the matter, they should obtain a ruling from the tax authorities. Where VAT applies, affected suppliers should take action to register for VAT, adjust customer contracts and prices accordingly, issue South African VAT invoices, and comply with their VAT payment and reporting obligations.

What should we do if we supply e-services?

1. Identify whether you supply electronic services to South African residents that are covered by the new rules (including supplies to individuals, intercompany charges, B2B and B2C supplies).
2. Quantify your supplies to South African recipients. Will you exceed the threshold? When?
3. Prepare to file for a VAT registration as soon as possible.
4. Identify your VAT reporting obligations going forward and how you will meet them (e.g., ensure you will be able to identify affected sales, submit reports on time, supply the information required and comply with invoicing rules).
5. Consider the impact of the new rules on your reporting systems, contracts and pricing. For example, can you add VAT to your prices? Do you need to update your website?
6. Consider the impact of the new rules on any other activities you currently undertake in South Africa (e.g., sales of goods).
7. Stay connected to developments as more details are released about the new provisions.
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About EY’s Tax services

Your business will prosper as you build it on strong foundations and grow it in a sustainable way. At EY, we believe that managing your tax obligations responsibly and proactively can make a critical difference. Our global teams of talented people bring you technical knowledge, business experience and consistency, all built on our unwavering commitment to quality service – wherever you are and whatever tax services you need.

We create highly networked teams who can advise on planning, compliance and reporting and help you maintain constructive tax authority relationships – wherever you operate. Our technical networks across the globe can work with you to reduce inefficiencies, mitigate risk and improve opportunity. Our 35,000 tax professionals, in more than 140 countries, are committed to giving you the quality, consistency and customization you need to support your tax function.

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EYG no. DL1026
ED 0115

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