

# Taking Your Business Global

## *10 Important Tax Issues to Consider*

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## Introduction

The last 15 years has seen a paradigm shift in the ability for even the smallest business to reach across national borders and become international in its trading model. Many a business owner is actively considering expansion to other countries and continents, if they haven't already done so and it has never been easier to accomplish this goal. With 95% of the world's population residing outside the boundaries of the U.S., it is no surprise that U.S. businesses are looking to the international community to grow their markets and profits. However, the simple fact that overseas markets are physically accessible does not necessarily mean to say that the act of "going global" is an easy process. For companies looking to leverage expansion opportunities, the associated tax implications related to their operations, pricing, delivery and selection of office location can be daunting.

How did this shift to a global marketplace come about? The rise in globalization has resulted from the evolution of two broad business phenomena: the first involves the immense reduction in the cost of going to market, primarily aided by the growth of the Internet, and the second is a result of the increased use of outsourcing for manufacturing, packaging and service delivery. The significant populations of India and China provide not only sources for inexpensive labor and products but also supply a large number of potential consumers. Helping to fuel globalization is the improvement in international freight movement which has become quicker, cheaper, and easier.

Globalization also brings with it many risks; risks that are mainly economic in nature but also those that can be potentially damaging to a company's reputation. Entries into new markets require sufficient infrastructure to support the sales activity. Along with establishing infrastructure, companies need to understand the cultures and social norms of the countries they enter. This entails going well beyond understanding language and currency; it also includes fully absorbing the legislative environment of the local country regarding:

- Business registration
- Contract and employment law (which often does not conform to U.S. or even European standards)
- Consumer protection measures
- Import and export restrictions and licenses
- Banking regulations (which have been tightened significantly since 9/11, making even the opening of a bank account a tedious and time-consuming process)
- Principal vs. Agency legislation
- Accounting and Tax law (it is important to understand both US and local legislation, as the global network of tax treaties can impact at both ends)

Of all the tax types that a U.S. company is likely to encounter as it ventures overseas for the first time, Value Added Tax (VAT) is by far the most widespread of the transaction taxes. With more than 140 countries employing such a tax system, it is difficult to avoid contact with it once a business steps beyond U.S. borders.

Business owners need to ask themselves: Do I have the knowledge and the resources to cope and comply with other countries' taxation rules and regulations? What types of taxes will apply to my business? The tasks of collecting, reporting, audit and defense are not insignificant and require constant vigilance.

## Managing Indirect Taxes in a Global Business

Studies from leading consulting firms agree that indirect taxes, such as VAT or Goods and Services Tax (GST), will play an increasingly important role in respect of the resources that multi-national corporations will devote to their global compliance effort in coming years. From a study of 500 large corporations in 22 countries, KPMG reports that:

- 75% of global businesses anticipate a growing governmental reliance on indirect taxation over the next five years.
- 50% of global finance directors rated VAT errors and compliance as a top tax risk.
- 66% of global businesses expressed the need to increase employee awareness of VAT through additional training.
- 42% of global businesses see a need to invest in improved VAT systems and technology.<sup>1</sup>

Similarly, in a PricewaterhouseCoopers study titled “Paying Taxes 2008: The Global Picture,” it is noted that:

Transparency around the tax contribution has therefore never been more important, to ensure that the impact on business and society in general is fully understood...

To consider the full impact of the various business taxes, both their tax cost and their compliance burden need to be considered. Indirect taxes and consumption taxes can add substantially to compliance costs.

For U.S. companies, the learning curve regarding VAT and other indirect taxes can be steep and expensive. Nevertheless, it is important to understand the tax landscape of your expanded market reach in advance of your first sale or the establishment of any form of local presence.

## The Top 10: Important Tax Issues to Consider

The term “indirect taxes” covers a broad spectrum of tax types and, as such, presents numerous business risks and exposures. So what are the top indirect tax issues you need to consider when expanding into other countries? The checklist below captures the major tax scenarios and provides further information you’ll need to manage a multi-national tax position.

### #1 VAT Registration: What are your obligations?

The first and vitally important thing to understand is that registering your company to do business in a country is not necessarily the same as registering it for VAT purposes, as the two processes do not always go hand-in-hand. Registration for VAT is often a separate activity and it is incumbent upon the seller to register for, collect and remit tax and report on VAT taxable transactions. In some cases, VAT registration can take up to 3-6 months to be processed, so thinking and acting ahead of time is critical if deadlines are to be met.

Your VAT registration position is normally dependent upon the specifics of your business. Some of the factors taken into consideration are:

**Revenue level** – most countries have a revenue threshold that dictates whether VAT registration is necessary. If expected annual revenue is below the country’s threshold, VAT registration may not be compulsory, though you may still want to take advice on whether to register voluntarily in order to reclaim VAT that is charged by your local suppliers. As a general guide, registration thresholds can run from a very nominal sum up to \$100,000 or more in some locations such as U.K and Singapore.

**Nature of physical presence** – issues surrounding permanent establishment are not dissimilar to those encountered under Income Tax law. Again, the position differs from country to country, with some territories maintaining that a physical presence alone (e.g. an office or members of staff) will require a local VAT

<sup>1</sup>“Indirect Tax Increasingly Important for Global Businesses,” published May 20, 2008 by KPMG.

registration; others provide that maintaining a server in their country will necessitate registering; and still others require registration if any of your customers belong within their borders.

**Type of transactions conducted** – not all transactions are taxable for VAT purposes and not all transactions give rise to a VAT registration requirement. For example, sales to business customers can often have the tax self-accrued by the customer (as occurs with Use Tax in the U.S.), so obviating the need for the supplier to register. Note that, in many countries, consumers have no mechanism for self-accruing tax, so rules related to B2C supplies often vary from those applying to B2B supplies. Some services (such as financial services, education and healthcare) are exempt from VAT, so they do not usually trigger a VAT registration either. It is, therefore, important to understand the tax consequences of the transaction types that your business undertakes.

**Method of delivering services** – the VAT rules around the supply of services can be very complex and is in the process of changing radically within the European Union. The main issue relates to the “place of supply” rules, which identify the correct taxing jurisdiction for such supplies. Different types of service can be taxed in different ways so it is not easy to provide generalized advice in this area but note that supplies delivered across the Internet may be taxed differently from the same services supplied in the traditional manner.

**Shipment terms for delivery of goods** – strictly speaking, the commonly used shipping terms (INCOTERMS - e.g. FOB, CIF, EXW) do not dictate the location in which the title to the goods transfers from seller to buyer but rather they indicate where the risk in the goods transfers. Nevertheless, many companies (and even some tax authorities) use the INCOTERMS as de facto tax jurisdiction identifiers. Therefore, if you ship goods under the terms EXW (ex-works), the taxing jurisdiction could be identified as being the origin location and if you ship under DDP (delivered duty paid) terms, that could be construed as a supply taking place in the destination location. In these two examples, you could be required to account for VAT at the origin

or destination, depending on the shipping terms used. It is important, therefore, that contractual and shipping terms be clearly considered and defined before entering into any trading arrangements in order to avoid unexpected VAT results.

## #2 VAT Liability: Investigate the rules country by country

There are more than 140 countries that levy some form of VAT and each has its own set of rules for determining the tax rate and applying the tax to supplies of both goods and services. This variation in rules and regulations creates an environment ripe for error, liability and penalties. Some of the factors that contribute to the risk are:

- A taxpayer’s lack of knowledge of country-specific VAT taxability laws and procedures can lead to incorrect VAT calculation and reporting.
- Place of supply rules add confusion when moving supplies cross-border so that, even if the tax is calculated and reported, this may be done in the wrong tax jurisdiction which is, again, an error subject to penalties and interest from the correct taxing authorities.
- Within the EU, derogations (legal exclusions from the European VAT Directives) or simplifications may alter VAT liability from one country to the next.
- Understanding who must account for VAT – normally the seller has liability for compliance with VAT laws, though this is changing in many countries so that the tax authorities may pursue customers instead. In some instances, business customers (B2B supplies) can self-accrue VAT.
- There are many requirements surrounding the eligibility of a taxpayer to reclaim input VAT charged to him by his suppliers. Typical issues that arise focus on documentation requirements but taxpayers must also remain up to date on any relevant legislative changes as well as developments in national and European Court of Justice case law.

It is worth noting that the global average VAT rate is 18% on both sales and purchases, which is significantly higher than the U.S. average sales Tax rate of around 8.5%. In the E.U., the standard rate of VAT falls between 15-25%, with the national average being closer to 20%. Management of the country-specific processes around this tax can be extremely challenging and potentially costly when errors creep into the mix.

**Common Penalties** – Every country levies fines or penalties for failure to comply with the local taxation rules. As VAT is a self-assessed tax, it is particularly prone to fraudulent activity, so the applied penalties are usually tougher than in some other tax systems. These penalties are mostly enforced for failing to submit the necessary paperwork or funds, or for not being timely. The most common penalties are applied in respect of:

- Late or non-registration
- Under-declaration of taxes due
- Late filing of returns
- Late payment of tax
- Failure to submit statistical reports such as Intrastat or European Sales List reports
- Criminal sanctions for fraud

### #3 Imported Goods: Recoverable and non-recoverable costs associated

Another indirect tax consideration surrounds the taxation of imported goods; typically goods are charged both VAT and a customs duty when they are imported into a country where a VAT system operates. VAT is applied at the published rate for the country, whereas customs duty is based on the valuation, origin and classification of the goods in question. It is critical to understand that customs duty is a non-recoverable cost for the importer and therefore must be factored into the overall sales price of the goods being imported. VAT taxes applied to imports, on the other hand, may typically be reclaimed, so they generally do not represent a permanent cost to the importer.

When importing goods, it is necessary to consider these issues:

- Do my goods require certification (such as importor export licenses)? Especially since 9/11, many of the world's customs authorities have clamped down on import procedures and require certification of certain types of goods under recent international shipping arrangements. Before sending goods abroad, check whether or not the type of goods concerned require any form of certification in the U.S. before shipping.
- Who will be the Importer of Record? The Importer of Record is responsible for paying the taxes on the importation. If possible, it is advisable to have your customer be the Importer of Record to avoid having to make claims for import VAT as a foreign claimant. Such claims (where available at all) often take 6-12 months to be refunded, which is a situation well worth avoiding. It is strongly suggested that sales contracts be clear on identifying the Importer of Record and that the receiving company in the destination country should usually take on that role and responsibility.
- How will I manage the customs clearance of my goods? Typically businesses use one of three modes for customs clearance and payment:
  - Cash, which is fine for one-off shipments but very inefficient if you are going to be importing goods on a regular basis.
  - Third-party clearance agents (such as FedEx, UPS, DHL, etc.) who will pay and recharge the applicable import taxes and costs.
  - Set up and use a VAT and Duty Deferment Account, which is simply a credit account with the local customs authority that is settled monthly. This is the method that regular importers generally prefer.

- Would using a bonded warehouse be of benefit? This is a useful cash flow solution when the inventory will need to be stored for a longer period of time, as any applicable import VAT and duty payments are suspended until the goods are removed from the warehouse and put into “free circulation.”
- How will I recover import VAT? There are essentially two options. The first is that, as a U.S. business, it is possible to make a refund claim direct to some countries’ tax authorities (mainly northern European countries). For the E.U., these claims are filed under the 13th VAT Directive and there are several U.S. based agencies that will assist with that process (for a fee). The alternative method of reclaiming VAT is to obtain a VAT registration in the relevant country and apply for a refund through the regular VAT return filing process. The upside of this option is that the tax will be refunded much more quickly and regularly. The obvious downside is that you will have to submit VAT returns and meet a raft of compliance requirements in foreign countries.
- How will shipping costs and import taxes affect my pricing? If you are going international for the first time, you will need to revisit your current supply chain and product pricing structures. It may make sense to source your products from different, lower cost locations if they are to be shipped to different parts of the world (e.g. source from China if the goods are destined for the Asia Pacific region; source from Netherlands for European supplies, etc.). It is worth noting that local or regional sourcing becomes increasingly attractive not only because the goods themselves can be sourced more cheaply but also because, as the cost of oil rises, this directly impacts on the cost of shipping goods over longer distances. On the pricing side, you must factor into your pricing any shipping costs including freight charges, insurance, customs duty on import, customs agents’ fees, demurrage charges, warehousing and handling fees, break-bulk charges and so on.

#### **#4 Supplies Made Over the Internet: Rules for consumer sales**

In 2003, the EU introduced legislation regarding “supplies of services made by electronic means.” The effect of these rules mean that a non-E.U. business selling online services, such as web site subscriptions and downloads, to E.U. consumers, are required to register for VAT in the E.U. and charge VAT according to the location of their customers. As so many businesses now operate Internet sites, this legislation has a broad impact on non-E.U. companies. As with so many tax areas, the devil is in the detail when it comes to managing this aspect of a business, so it is strongly advised that you take professional advice before starting to make supplies of services across the Internet to E.U. consumers.

#### **#5 Intra-EU Sales to Consumers: More special rules apply**

Another recent development within the E.U. involves supplies of goods or services from a business in one E.U. country to a consumer in another Member State. This is referred to as “distance sales” and special rules apply to such intra-E.U. sales. Each Member State has established a distance sales threshold so that, up until the point at which the threshold is breached, the seller charges VAT on the basis of his own country. Once the threshold is reached, the seller must register for VAT in the consumer’s country and charge the local rate of VAT. For example, France has set a threshold of Euros 100,000. If a U.K. supplier makes B2C supplies from U.K. to France, he will charge the U.K. VAT rate of 17.5% on these sales until his revenue from French consumers in any 12 month period reaches Euros 100,000. Once that threshold is breached, he is then required to register for VAT in France and charge the French VAT rate of 19.6%. This legislation requires the seller to carefully monitor total sales to consumers by country in order to avoid errors and penalties.

#### **#6 Consignment and Call-Off Stocks: Understanding where the tax burden lies**

Many U.S. companies hold inventory (often spare and replacement parts) in overseas locations, close to where their customers are situated. Local sub-contractors are

then engaged to service the local customers using the stored inventory. This inventory remains the property of the overseas principal company until it is used, which means that the foreign entity is deemed to be the importer of record of the goods into the local country. As mentioned earlier, this presents issues around how to recover the import VAT that the importer of record is liable to pay when the goods first enter the country. Further, when the goods are delivered to local customers, the local rate of VAT needs to be applied and therefore the business needs to have local VAT registration.

That said, the E.U. has introduced a VAT directive that simplifies the treatment of consignment and call-off stocks under which the liability to account for the local VAT switches from the seller to the buyer, so the customer can self-accrue the tax. This has the effect of relieving the seller of his obligation to register for VAT in that country. The problem is that this directive has not been implemented in a uniform fashion across all E.U. Member States, so taking professional advice in this area is recommended on a country-by-country basis.

### **#7 Beyond VAT and Customs Duty: Environmental and social taxes**

It should also be noted that, in addition to VAT and customs duty, many countries levy indirect taxes in pursuit of their environmental policies and social programs. Often, these taxes are not visible on an invoice but they lurk behind the scenes and form part of the purchase price of goods and (more often) services. U.S. companies venturing abroad should always check to see whether any of these tax types might be applicable to the goods and/or services they are supplying. If they are, they must be factored into the selling price. Some of the possible tax types include taxes on:

- Landfill use and dumping (e.g. U.K.)
- Carbon emissions (several European countries)
- Packaging and plastic bag use (e.g. Ireland)
- Air passenger duty (e.g. U.K.)

- Education programs (e.g. India)
- Insurance premiums (most European countries)
- Excise duty (all countries)
- Common Agricultural Policy levies (all E.U. countries)

### **#8 Direct Taxes: Income Tax and others**

Although the focus of this article is indirect taxes, no U.S. business should begin its internationalization project without considering the possible effects of direct taxes, which bring with them a variety of issues to consider. For example:

- Permanent establishment rules can be complex and very often trigger a VAT registration liability. Few countries' VAT legislation goes into any real detail around permanent establishment rules, so local income tax rules on the subject tend to hold sway in this area. As a very general rule, if you have a permanent establishment in a country for income tax purposes, you are likely to require a VAT registration also.
- Social security payments can be high in most European countries. This is an important factor that should be considered when planning how you will do business abroad. Should you recruit your own staff, use local agents, etc.? It should be remembered that every country's employment law is quite different and many can create problems around employment termination and overall cost of employment. These factors should be checked thoroughly before heading down any particular path in any individual country.
- Transfer pricing may cause issues when transferring goods between related companies (e.g. a U.S. parent company selling to its overseas subsidiary). All countries have special transfer pricing rules that prevent associated companies selling to each other at artificially low prices to avoid local taxation.

- Repatriating profits can be costly from a direct tax perspective if not structured carefully. This is another area where tax treaties come into play and some careful strategic planning may be essential if a significant chunk of repatriated profits are not to be lost “in transit” to the tax system. This is a highly complex area of the tax world, so professional advice is always recommended here.
- Withholding tax applies, in most countries, to inward supplies of management services, technical services, royalties, licenses and patents. The effect of this is that the amount charged in respect of these services is not necessarily the amount that the customer will pay. For example, if a U.S. company was to charge a management fee of \$50,000 to an overseas customer who is in a country that levies a 5% withholding tax on management fees, then the customer will pay that 5% (\$2,500) direct to his local tax authorities and remit only \$47,500 to his U.S. vendor, together with a certificate showing that the balance has been paid to his local tax authorities. This creates a problem at the U.S. end, as the amount received does not reconcile to the invoice value. Further, in most cases, the U.S. company is able to use the tax payment certificate to reduce his tax liability in his U.S. income tax filings, as the tax paid abroad should be off-set against domestic tax liabilities to prevent double taxation. It is critical, therefore, that he carefully manages the collection and retention of overseas tax payment certificates as, without those documents, he would be unable to take the tax credits he is due.
- The U.S. tax authorities require the reporting of global revenues. Note that, for reporting purposes in the U.S., revenues generated in any part of the world should be filed. That is not to say that all such revenue will be taxed domestically, as the global tax treaty network will relieve some of that income.

The most significant direct tax to consider is income tax. The following chart, created by PricewaterhouseCoopers

and the World Bank, lists selected countries and shows their Total Tax Rates (calculated as a percentage of profit and includes all taxes paid in Year 2 of the company doing business).

Country	Total Tax Rate	Global Rank
Ireland	28.9%	23
Switzerland	29.1%	24
Luxembourg	35.35%	47
U.K.	35.7%	52
Netherlands	43.4%	88
U.S.A.	46.2%	102
Japan	52.0%	133

The purpose of this chart is to illustrate that basing your operations in, say, Ireland (where the overall direct tax burden is 28.9%) can be considerably more beneficial from a tax standpoint than basing the same operations in the U.S., where the same tax rate is 46.2%. Thinking longer term, you may want to bear this in mind as you plan out the structure of your overseas business, as the later restructuring of a larger, more established business can be problematic and costly.

As a matter of interest, the countries that came out of the PwC/World Bank study in the top positions with the lowest Total Tax Rates were Vanuatu (8.4%), Maldives (9.1%) and United Arab Emirates (14.4%).

### #9 Structuring Your Business Operations: Understanding the tax implications

For a great many companies, the traditional buy-sell arrangements that have underpinned business operations for a long time are no longer the most appropriate or efficient way to conduct their activities, as a multitude of new business models have been introduced over the last 20 years that streamline cost bases, enhance supply chains, reduce tax burdens and ease compliance workloads. Before launching a business into overseas markets, there are several popular business models that should be considered but remember that each of them has its own direct and indirect tax consequences. Just a few examples of things to consider include:

**Toll Manufacturing:** In this arrangement the principal company purchases and owns the raw materials throughout a manufacturing or processing cycle but sub-contracts the actual manufacturing or processing to a third party. The benefit of this is that the principal is able to control the cost of raw materials and may be able to leverage greater buying power. However, from a VAT perspective, moving one's own raw materials and unfinished goods from place to place for different phases of processing can incur tax liabilities. VAT registrations may be required for every country the goods move through which, in turn, may result in a customs duty (non-recoverable) cost. Ways to circumvent this are the use of contract manufacturing (which is the same as toll manufacturing except that the principal does not own the raw materials) or bonded warehouses and trade free zones, which can be used to suspend liability to pay VAT or duties on imported goods.

**Commissionaire Structures:** Many companies want to recognize sales revenue in their headquartered country rather than in each locality where they sell through subsidiary companies. In order to do this, they transform the local subsidiaries into commissionaires which behave much as a sales agent would. Sales made by the commissionaires are recognized as the revenue of the principal and the true revenue of the commissionaire is simply his sales commission. The effect is to reduce the amount of local direct taxes paid and to centralize revenue recognition (hopefully in a low tax jurisdiction). Significant restructuring costs can occur when moving to a commissionaire structure from a traditional buy-sell arrangement, so consider whether it is worthwhile creating this model from the outset.

**Central Purchasing:** Typically companies utilize a centralized purchasing structure to streamline operations and realize economies of scale in the purchasing area. In a multinational corporation, however, the central purchasing business model can result in higher taxes (especially VAT and non-recoverable import duties) due to changes in the VAT footprint for the company. It may also result in considerably more tax-complex supply chains, as there is typically a great increase in the number of drop-shipment deliveries being made.

**Outsourcing:** A popular trend in all industry and service sectors, outsourcing can reduce costs but at the same time may increase a business's tax burden. The primary reason for this is that, when a company undertakes certain functions in-house, it does not incur any VAT charges, as there is no VAT attached to staff salaries and benefits. However, when the same task is outsourced, the supply of that service becomes taxable for VAT purposes, so increasing the amount of tax incurred. For businesses that are able to fully recover VAT charged to them by their vendors, this simply represents a cash flow issue but, for those that are unable to recover all their VAT on costs, this would represent a real cost to them.

As stated at the outset of this article, indirect taxes will continue to have an increasingly significant role in the way that multinational companies structure themselves and go to market. While new markets offer tempting opportunities for increased sales and profits, the expanded geography brings with it the burden of local tax compliance and reporting.

## #10 Managing New Markets through Technology: Using tools to minimize errors and improve efficiency

Updating, managing, and reporting on VAT across a number of countries is a difficult task and when left to manual processes, may expose businesses to enormous risk. Technology solutions can assume much of the tax work and provide an additional layer of comfort to businesses by ensuring that the tax information being used for calculations, payments, and reporting is updated routinely by tax professionals. ERP systems do not offer the data content, calculation capability and granularity of reporting that such applications can deliver, so there is an increasing trend towards using tax engines for international transaction tax compliance rather than relying on the native capabilities of ERP and other financial accounting systems. The business case and return on investment for using such applications increases along with the complexity of a business's supply chain model.

The most important technology solution to consider is the tax engine itself. Leading technology includes

country-specific research; if-then statement builders for custom scenario creation and new rule testing; and flexible and report generation. And, in the event of an audit, your technology tools can provide the historical data you need to mount a successful defense.

## Conclusion

Globalization will continue to shape the world economy and the country-specific rules and regulations will no doubt continue to change regularly. The compliance and cash management issues that accompany multinational VAT collections, payments, and reporting can be best addressed by the application of leading technology coupled with workforce education.

During difficult financial times, such as the current credit crunch, governments will look to supplement their revenues through more stringent enforcement of the tax rules and the application of fines and penalties. Legislation, such as Sarbanes Oxley, will also serve to drive a heightened focus on tax compliance.

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