Using Tax Technology to Strengthen End-to-End VAT Management

Fundamental Issues and How Technology Can Help

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1

Executive Summary

Today, VAT teams face multiple challenges within their core, interrelated processes of tax determination, compliance and audit management. In this paper, we'll examine the fundamental issues they face and investigate how technology can help.

In doing so, we'll explore a comprehensive approach to VAT end-to-end automation, see how this enhances the VAT function's overall performance and, ultimately, how it increases strategic contributions to the company.
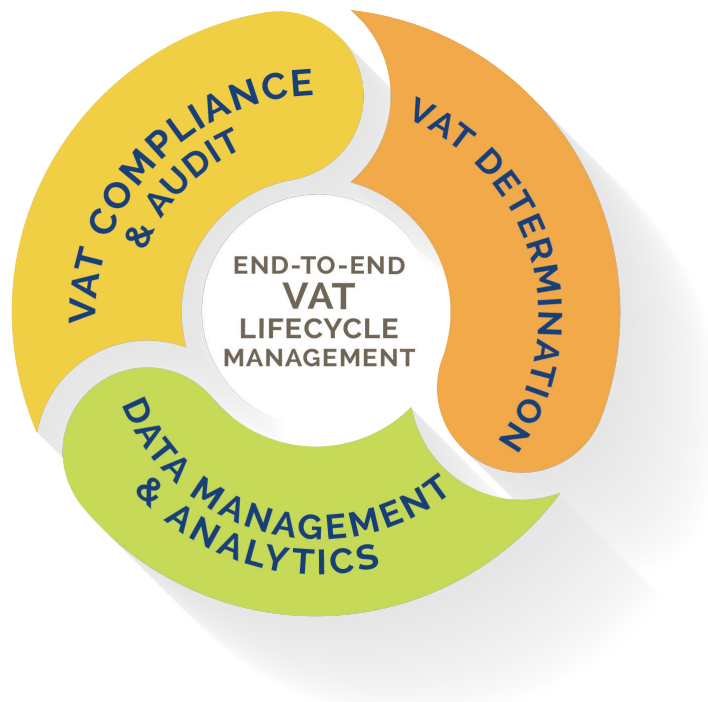
Diagram showing the core, interrelated processes within the tax lifecycle.

What Challenges are VAT Teams Facing Today?

Every day, global companies are met with the challenge of addressing complex VAT obligations. Because of this, they're also met with the challenge of encountering constant questions about whether VAT applies to transactions, how, when and where does it need to be reported, and what underpinning data needs to be available to support it.

Increasingly, these questions are difficult to answer. That difficulty has arisen partly because businesses are more global and their trading models more complex for VAT than ever before; partly because Tax Authorities across the globe have been very active in trying to increase tax take in uncertain financial times —and with direct tax revenues continuing to drop, the focus is falling more heavily on indirect taxes.

That activity by Tax Authorities has led to scrutiny on taxpayers at unprecedented levels, a general trend of increases in indirect tax rates, and a range of requirements to report more quickly with more data. The rise of VAT SAF-T type reports, the Spanish SII and the like are at the vanguard of a move to near-real-time reporting on a wider scale.

And that pain is felt most by VAT teams.

From a political perspective, VAT (and tax more widely) is in sharp focus. Any perception of wrong-doing is front page news, and no one wants to be the Head of Indirect Tax telling their CEO that a journalist is on the phone or that their presence is requested at a governmental committee staffed by vote-seeking politicians.

In an effort to respond to these volatile social, economic, and political conditions, companies are changing their core strategies frequently. In doing so, driving shifts in legal structure, operating models, product and services lines, as well as geographic reach, affecting how VAT impacts related transactions.

Together, these factors greatly increase the complexity of VAT management. Many companies are therefore turning to technology for help. In part, because innovation within the industry is instrumental in increasing accuracy and, as a result, overall compliance. But also, because it reduces preparation time, improves

documentation, and creates the necessary audit trail and governance structures throughout the VAT lifecycle.

Core Challenges in VAT Process

Each core process within VAT management poses its own unique challenges for automation and centralisation. These are explored in more detail below:

Tax Determination

For any transaction, companies must determine:

- Whether VAT applies

- If so, in which country/jurisdiction does it apply

- Who is liable for that VAT and at what rate?

Importantly, if the transaction is 'VAT-free'—exempt, zero rated, out of scope or similar—a business may need to fulfill additional requirements to substantiate such a VAT treatment.

A tax engine fully automates tax determination for all transaction types, and drives invoice requirements and accurate VAT posting, using real-time integration with a company's ERP.

Depending on the type of transaction, this process of tax determination requires a series of complex, interdependent calculations fuelled by a large data set to ensure the right VAT treatment. For example, when a company has multiple VAT registrations, it needs to determine which registration numbers must be used for a specific transaction. A mistake could mean the transaction being reported in the VAT return of the wrong country, and the company paying VAT in the wrong country. The risk is effectively doubled.

The risk is further extended when chain transactions are involved. Consider this…

If a company is selling goods to a customer in a different country, while shipping the goods to that buyer's customer (or even further down the chain), it's difficult enough to determine the right VAT treatment

for each case. But automating that, without having to revert to defaulting, is where the task becomes much, much more complex.

Further issues then arise when a company has a special arrangement in place. The usual exporter status in Italy, for example, might be cash accounting, or part of a VAT Group. Once the correct VAT treatment is determined, additional rules around invoice formalities are taken into consideration. However, ensuring that each sales invoice contains the correct tax data for every country involved is not always possible in Enterprise Resource Planning (ERP)/billing/finance systems.

VAT determination is not only critical for sales transactions. Indeed, many companies face the risk of incurring substantial fines and costs resulting from incorrect accounts payable (A/P) invoices. By definition, businesses have much less control over their A/P process than their A/R process - to a degree, they are at the mercy of their vendors. When vendors charge the wrong VAT, or fail to issue invoices satisfying all formal requirements, the receiving company is exposed to VAT risk. When an A/P clerk with limited (at best) VAT knowledge sees a VAT-free invoice, the risk of missing reverse charges is clear and substantial penalties can accrue, even for fully-taxable companies —the risk for partially exempt businesses is clearer still.

It's therefore critical for companies to review and validate all incoming A/P invoices against local VAT regulations. And while this is relatively easy for a business that deals with only a few invoices each month and fully controls the A/P process, it's a nightmare for larger companies who may have outsourced or taken that process offshore. A/P outsourcing, especially to low-cost locations, has been a well-trodden path for many companies and comes with many inherent benefits: however, as every VAT leader knows, those outsourcers are paid by reference to the volume of invoices processed, not the quality of the tax coding. The math is simple—manual processes equals risk of non-compliance.

Technology – Supporting Determination
Historically, VAT determination in ERPs has been performed in one of two ways. The first is by clerks who manually select a tax code from a lengthy, ever-changing list; alternatively, it's calculated through hard-coded logic set deep within an automated system.

Neither is ideal. The first is prone to error. The latter are typically limited to simple transactions and can become invisible to the tax team and difficult to update.

To alleviate these issues, sophisticated tax engines have come into play. Typically, these fully automate tax determination for all transaction types, and drive invoice requirements and accurate VAT posting using real-time integration with ERP.

A tax engine can deliver these capabilities, as it contains all current, company-specific VAT rules and rates, and triggers off factual transactional/master data contained in the ERP, instead of hard-coded rules. This allows it to be dynamic, and to handle any transaction based on the data that is fed to it. Through regular software updates, the latest tax rules and rates change data are added, easing the burden on the tax team. Similarly, valuable IT resources needn't be wasted on simple software updates.

Another benefit is that as business requirements change, tax teams don't have to waste time or consulting expenses adding rules within a highly-customised native environment. Nor need they look for expensive solutions to the problem of running out of tax codes. Instead, they can control most of the limited changes and testing required for engine modification themselves, helping to overcome challenges around multiple VAT registrations, special regimes and more.

When completing the transactional cycle, a company must ensure VAT is accounted for correctly in the general ledger. This includes confirming VAT paid and deducted is recorded on the correct account (including reverse-charge transactions), and is coded correctly. Today, only technology can ensure this kind of accuracy.

VAT Compliance
For companies operating internationally, VAT compliance is complex and challenging. Returns can differ significantly from country to country, and it's often difficult even for tax professionals to ascertain which transactions need to be reported.

Some returns require little detail. Others are microscopically granular. In many cases, boxes will be similarly labelled across different countries, but require different data. Depending on the country, credit notes may need to be deducted from base amounts, or they will not be allowed to be deducted at all. This leads to

errors, especially when the VAT compliance process is centralised and one team is supporting part of that process for a region.

Unfortunately, it can be difficult—sometimes, even impossible—to find clear guidelines for the returns. And even then, language barriers may conspire to further complicate matters. Additionally, EC Sales List (ESL) and Intrastat returns tend to be complex given that they require data that often resides outside of the financial modules of the ERP. While some countries also require additional returns or submissions to be filed, like the VAT SAF-T and SII purchase listings.

Despite this complexity (or perhaps because of it) many companies operate highly manual, spreadsheet-driven VAT compliance processes. Or alternatively, they simply outsource their tax processes to expensive third parties. For companies that run their own VAT compliance process, returns are often completed locally by finance and accounting professionals—professionals who have other responsibilities and may not possess deep tax expertise, leaving the company exposed to VAT compliance risks.

VAT compliance applications can generate signature-ready returns and/or returns files ready to upload to government websites.

VAT Compliance: How Advanced Tax Technology Can Help
There are VAT compliance applications on the market that pull data from ERP systems and/or tax engines, generating signature-ready returns and/or returns files ready to upload to government websites.

These solutions normally cover all VAT-related filings including VAT returns, ESL, EPL, Intrastat, and others that form part of the submission. They also generate VAT compliant A/P and A/R ledgers that form the basis of the VAT return.

They also allow companies to validate their data and returns, offer drill-down functionality for each of the boxes and retain an audit trail of any changes. Businesses can store the final submitted returns and ledgers for retrieval at a later stage, as required.

This type of automation saves time and reduces risk of errors by eliminating manual data entry (often undertaken by multiple people, sometimes outsourced, using disparate spreadsheets). Some systems even guarantee both an English and native language version of the return, for absolute clarity. In many cases, the application will also tell you, in English, which type of transaction is to be reported in a specific box.

Managing VAT Data for Reporting and Analytics

The realities of big businesses' systems landscapes are such that it is very rare that all reportable data sits in a single finance system, with complete confidence in the existence and quality of master data.

The reality is that data can sit across multiple systems/locations, multiple ERPs, multiple flavours of a particular ERP, other legacy systems, e-Commerce platforms, procurement platforms, Travel and Expense system and logistics systems for statistical reporting data. If those VAT Return products are only as good as the data flowing into them, think of how much more value you will get from our investment if that data can be made good upfront.

This is where the true difficulty for large businesses lies when it comes to VAT compliance. The preparation of that data, pulling it together from disparate system, heavy lifting of it from spreadsheet to spreadsheet with macros, the multiple manual processes. Businesses are spending many thousands of man-hours each year just to get hold of the data in the first place, then countless more to get that it ready for onward reporting. And they are doing that slavishly month after month after month.

Again, technology can assist here. Imagine a system that can automatically pull that data together, unify it into one common format, validate its quality and enrich it for missing/erroneous data and give VAT team's direct access into that data for easy visibility. Well, that technology is out there, and it can save businesses the time of low-value activity, allowing VAT teams to concentrate on higher-value activities that can actively drive forward the competitive edge of their business.

And with all that transactional data, stored and accessible in a common, unified way, businesses are

now seeing that they can leverage that for other tax and finance reasons—giving business true insight to their overall positions from a single platform. Direct Tax teams are also faced with a range of new, global reporting at a level of granularity that they are not historically used to—surely it is sensible and logically to bring all that reporting together in a consistent way? It can be done, and only technology can make this achievable.

VAT Audit Management

Regardless of the trend towards (near) real-time data submission, businesses still face challenges if audits are being announced years after the original filing date. This time lapse, combined with a cumbersome, often spreadsheet-driven process, can make it difficult to find a reliable copy and back-up of the filed returns.

Because of this, tax professionals often waste inordinate amounts of time working through multiple versions of returns and underlying workings. From this, they then attempt to piece together a ledger that matches the amounts on a return that might be five or more years old.

In such cases, even the most skilled and well-organised tax functions can expect to invest hundreds of hours manually poring over data they're unfamiliar with and reconstructing processes that were not clearly defined, possibly handled by staff that have since left the company.

And then there's the tax authorities to consider, who typically start their audits by matching the submitted return to the A/P and A/R ledgers and then drilling into invoice details. They may request transactional details over a specific time period relative to transactions that were identified as potentially incorrect. Companies with multiple data sources will spend significant time and effort providing this level of detail.

Then there's the 'what ifs'. For instance, perhaps late adjustments booked after the return was filed mean that detailed, transaction-level data in the ERP doesn't match the return under audit. Discrepancies like this typically result in negotiation of a payment, or even payments, to the tax authorities. And often, such payments are rarely of an insignificant amount.

VAT Audit Management: How Advanced Tax Technology Can Help

Today's VAT compliance applications can provide a complete audit trail and storage of the final submitted returns together with the accompanying A/P and A/R ledgers. This means that when an audit is announced, all returns and underlying ledgers can be easily located in a single application.

Since processes are automated, the risk of manual errors is reduced, and tax data is kept updated. It also makes it easy to answer detailed questions from the tax authorities without delay. Technology like this will become even more important as tax authorities continue to demand ever more granular data with increasing frequency.

> *Compliance applications provide a complete audit trail and storage of the final submitted returns together with the accompanying A/P and A/R ledgers.*

Comprehensive Tax Automation Capabilities for Tax Performance Management

Today, it's possible to take tax automation one step further and embrace a systematic approach, referred to as "Tax or VAT Performance Management." This holistic view of VAT management focuses on quality assurance and continuous improvement activities within the VAT function. But it also provides the common infrastructure necessary to monitor and manage overall VAT management in a more effective and efficient manner, driving real value for a company.

Quality Assurance and Continuous Improvement

As VAT experts know only too well, many factors beyond the control of the tax team can limit the speed and effectiveness of VAT processes—in particular, the quality of a company's data. This could be as simple as missing master data for customers, vendors, or products, but it can also be errors in order entry or the A/P process.

It's difficult to spot such errors, but crucial to catch them early in the process, correct them and address the root cause. Alas, as VAT processes are at the end of the chain, errors are usually discovered late and corrections often overlooked.

So, VAT teams are obliged to find different ways to gain access to transactional data in order to clean it up prior to running their month-end compliance processes. The access gained in such cases by the VAT team allows them to feedback to their companies with valuable insights that can be leveraged far beyond VAT.

Consider, for example, the possibilities to validate the supply chain set-up of a large group. Does the distributor in a certain country have customers in jurisdictions it should not? Is it certain that the tolling manufacturer is billing only services, and not goods? These tactics (and many more) exist to transform data into insight and will be of great interest to many stakeholders. Therefore, having transactional data available in a usable format affords the VAT team unlimited possibilities to ensure quality assurance and continuous improvement. And particularly in scenarios including:

- Logical tests around tax treatments (e.g. if you have a tax code for export, you should not have a VAT amount)

- Trend analysis

- Validating that intercompany transactions are booked consistently between businesses (e.g. if you sell from one intercompany to another one, and the sales invoice of the first one is an EU dispatch, do you have an EU acquisition at the A/P side for the second intercompany entity?), and validating that VAT return

- ESL and Intrastat returns for a certain entity/period reconcile

Leveraging these opportunities requires knowing where to find relevant data (often hidden in transactions recorded on different systems) without spending excessive time running queries and interrogating vast amounts of data in the hopes of finding actionable information.

Quality Assurance and Continuous Improvement: How Advanced Tax Technology Can Help

As noted above, advanced tax technology is changing the landscape by being able to unify data from multiple sources into a single, common structure that can be leveraged throughout the entire VAT lifecycle. Missing data can be inferred, or logic applied to the mapping, ensuring data ends up in the right place, ready for use further along in the VAT processes. That data can then be leveraged not only to run a clean and standard compliance process, but also for a variety of VAT applications, including:

- Reconciliation capabilities automating the VAT general ledger reconciliation and reconciliation between your general ledger turnover and VAT turnover

- Cash flow monitoring

- Transactional VAT analytics as mentioned above (e.g. validation in cases of domestic ship-from/ ship-to data, a VAT amount is shown for non-local reverse charge countries, validation that local reverse charge was applied correctly depending on local requirements, etc.)

- Business model validation, customised and modified to address scenarios unique to individual companies

- Data validation capabilities providing reporting on missing or inaccurate data

The pressure is on: VAT teams need to do more with less, which means embarking on a transformative technology journey now, not tomorrow.

Finally, the results of such processes should end up in a clear management dashboard, with drill-through capabilities. So the areas of both potential risk and opportunity are immediately visible, as opposed to being hidden in the depths of spreadsheets or finance systems.

Recommendations and Conclusion – The VAT Transformation Journey

VAT processes are complex, and tax technology is inevitable for organisations who need to better navigate their many challenges. But the pressure is on: VAT teams need to do more with less, which means embarking on a transformative technology journey now, not tomorrow.

Once that strategic decision has been made, the following should be considered.

People

VAT teams need to have the right people with the right skillsets. These people need to be supported with training and knowledge-sharing to ensure they remain current on the latest tax rules and regulations, as well as the latest technology.

Process and Governance

VAT teams should have lean, repeatable and documented processes and controls in place for all aspects of the VAT lifecycle, whether that's the regular compliance process or other processes such as managing tax audits.

Technology

Tax functions should have the right advanced tax technology in place that supports their unique needs as well as those of the organisation. To manage the increasing complexity, while elevating the value that the VAT team delivers, tax functions should have an effective management tool that helps measure and monitor performance. It should also ensure that resources are focused on areas where the function can deliver the largest impact.

Ultimately, it's a balancing act. Every company must consider its strategy and appetite for transformation, as well as its available resources; it must deduce the right way to leverage the right people, processes, and technology to improve its overall VAT performance and continuously monitor and improve it.

It is this holistic approach to VAT transformation that will take VAT teams from an operational hub to one that provides real strategic value to a business.

About Vertex

Founded in 1978, Vertex Inc. is the leading provider of corporate tax software and services to automate, integrate, streamline or outsource tax processes for companies of all sizes, from small to medium-sized businesses to global multinationals. Vertex provides solutions for all tax types with industry-specific solutions for retail, communications, hospitality and leasing industries.

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