Opinion paper

MEGATREND VALUE ADDED TAX

Four hypotheses on VAT compliance – February 2017

pwc

Multifaceted state and corporate sector task

In most European countries, value added tax (VAT) accounts for a significant portion of the domestic tax base. The obligation to collect and remit VAT has a considerable influence on the relationship between the state and the corporate sector.

This shared task of securing the funds for public spending hinges on a crucial, yet soft factor: trust. Accordingly, the actions of each tax authority play a role in outlining the depth of trust held. As a result a distinction can be made between three behavioral patterns. The conduct of some states suggests mistrust of taxpayers which in turn leads the authorities to take rigorous pre-emptive action against possible cases of tax fraud and impose excessively harsh fines for wrongful conduct. Other countries provide businesses with a certain degree of personal responsibility and rely on processes and procedures which ensure ongoing controls and observance of quality standards. And then there is the third type – Switzerland included – that perceive themselves as an impartial supervisory body which examines after the fact whether or not taxpayers meet their obligations properly.

Whatever the case, dealing with VAT in an efficient and rule-consistent way – in other words, being VAT compliant – is a key task for any company; and this in an ongoing dialogue with all involved parties, regardless of whether they are tax authorities, customers or business partners. The more networked and international the environment is in which a company operates, the more complex this challenge will be. Companies which ensure their tax liabilities are reported in good time, in the right amount and in the correct category, will be in a position to avoid mistakes, penalties and additional work and expense. Perhaps even more importantly, they will also be able to demonstrate their reliability and willingness as a corporate citizen to pay tax whilst at the same time managing their cash flow – a highly successful strategy for commercial sustainability.

Tax structures in the OECD area*

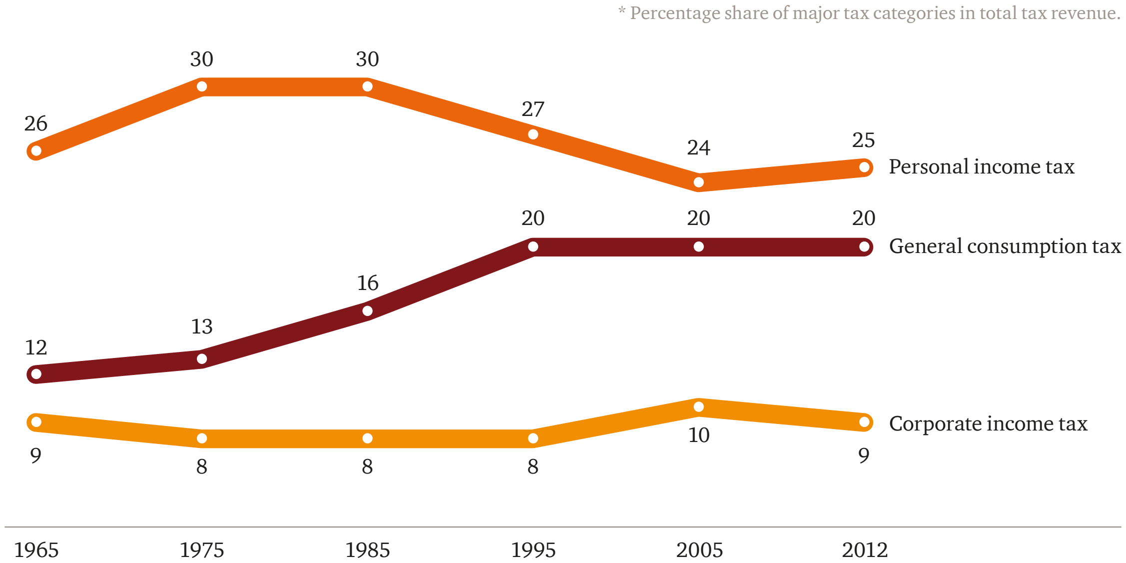


Figure 1: The trend in the OECD overall tax structure makes it clear that VAT has become a much more significant factor in recent decades.

The crowning discipline: VAT compliance

There are many facets to VAT compliance: a regulatory aspect, an economic one, and not least a very personal one. After all, depending on the given country, legislation and standards, an incomplete or deficient declaration can trigger legal proceedings not only against the company, but also against those responsible for the compliance. So within the company it takes well-designed structures, clearly defined processes and slip-proof control mechanisms to ensure this does not occur.

Robust, reliable VAT compliance is frequently underpinned by an application which draws on the existing financial IT systems of a company. At the desired frequency, transaction data is fed into the software which then takes over the job of properly qualifying and allocating the transactional data to the VAT return. It automatically tests the data for errors and identifies the risk potential.

The following pages delve into four hypotheses of relevance to sustainable VAT compliance. Through this exercise, we want to explain the variety of challenges companies face in mastering this discipline, stimulate thought on the subject, and show how companies can make improvements and view this topic as an opportunity rather than an annoyance.

Thesis 1:
VAT compliance
builds trust and saves money

Thesis 2:
VAT compliance
results in effectiveness and resource efficiency

Thesis 3:
VAT compliance
optimises vital cash flow

Thesis 4:
VAT compliance
avoids the risk of costly penalties

THESIS 1

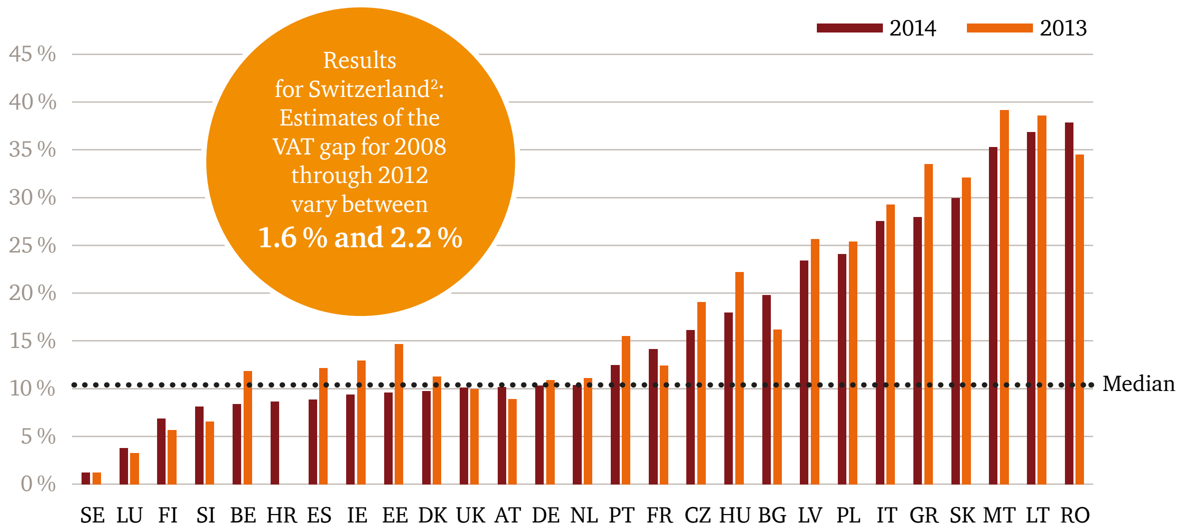
Those who gain the trust of tax authorities through their conduct not only foster better collaboration but also save money.

The facts

Tax authorities' use of electronic auditing processes has increased which in turn has led to demands of access to internal company systems. VAT-liable companies increasingly have to transmit their data to the tax authorities electronically and at very short notice. Spain, for example, will soon require in-coming and outgoing invoices to be electronically forwarded to the authorities within four days. In certain countries, the tax authorities gain access to information on credit card transactions. This enables them to trace orders placed abroad to comprehend which VAT amounts they have missed out on and to determine which foreign businesses should be registered for value added tax purposes.

In certain countries, the tax auditors have practically taken up permanent residency at companies. They continuously scrutinise VAT statements down to the last penny. Which in turn costs a company enormous amounts of money, time and staff effort.

VAT gap as a percentage of total VAT liability in 27 European states – 2014 and 2013[1]



1 Study and Reports on the VAT Gap in the EU-28 Member States: 2016 Final Report (2016). CASE – Center for Social and Economic Research: Warsaw

2 A. Moes (2013). Indikatoren der Mehrwertsteuer-Compliance. Eidgenössische Steuerverwaltung ESTV: Bern

Figure 2: The gap in the levying of value-added tax for 27 EU member states makes it clear that, year after year, states miss out on substantial VAT revenues.

OUR TAKEAWAY

Trust is becoming a key factor in the interaction between authorities, VAT-liable entities and other players in the value chain. If a tax authority is convinced a company has a demonstrable grip on its tax obligation and diligently levies, reports and remits VAT, the authority will refrain from conducting company audits. In a mutually trusting relationship with the authorities, fines are less frequently or more leniently imposed and errors in certain instances can even be remedied informally. It is frequently the case that this proof of trustworthiness can only be evidenced by the kind of flawless end-to-end process that a robust compliance application offers.

“Those who have a grip on VAT have a grip on their company.”

Michaela Merz,
Partner,
PwC Switzerland

THESIS

2

Automated VAT compliance avoids expensive loss of time and enhances the efficiency of a company’s core activities.

The facts

Handling transactions in a tax-compliant manner is a highly complex task. Many companies have delegated these tasks to well-educated employees. In the case of straightforward processes and a small volume of transactions, manual processing is a viable option. But when a company needs to deal flexibly with purchases and sales in a cross-border environment, and with a large number of involved parties, the manual approach becomes unfeasible. One reason is time constraints – because a single transaction itself involves numerous VAT-related parameters. Allocating as well as qualifying those factors in a rule-consistent, error-free way, especially in multi-layered processes, exceeds the time, knowledge and experience capacity of almost any human being, regardless of how reliable and well-trained they might be.

So the rule of thumb in terms of VAT is: the greater the amount of manual work, the higher the error rate – and the greater the efficiency loss. What happens when a reliable employee is absent due to holiday time or illness and a less experienced person has to fill the gap? Or when erroneous declaration settings have gone unrecognised for years? In such cases, the multiplier effect can kick in and expose the company to risks of unexpectedly high retroactive penalties, interest, and assessments for VAT; not to mention the substantial impairment of its cost and performance efficiency.

OUR TAKEAWAY

Man hours are freed up when VAT compliance is handled systematically on an automated basis; the responsible employees can then devote time to other tasks – value- adding tasks. This way, a company ensures that its personnel are not burdened or blocked unnecessarily and that it is deploying its resources in a targeted fashion. The resulting value-chain efficiency is especially important for companies which are successfully marketing their products or services outside the boundaries of their own country – because the more VAT systems and authorities that need to be complied with, the more crucial it is to ensure that the ultimate effects of one's VAT practices are not eroding the profits from those countries.

"The flood of VAT-related data can only be mastered if you are able to maintain a continuous overview of the situation."

Elizabeth Guy,
Senior Manager,
EU Tax, Meritor

THESIS

3

VAT compliance optimises one of the make-or-break key indicators: cash flow.

The facts

Companies which conduct business solely with domestic customers recover VAT paid on purchases in the form of input tax deductions. Businesses which make purchases abroad and file no VAT returns in those countries are able to request a reimbursement of the VAT they were charged. But in any case, the company must be able to identify and substantiate expenditures, such as travel costs or the purchase of products and services abroad, in its own data system. At many companies, precisely this kind of information is either unavailable, cannot be traced back to the source, or can be retrieved only with excessive effort. What is more, many invoices end up being settled twice.

Despite the fact that sizeable sums are frequently involved, many internationally active companies do not know which amounts have been paid to which supplier in which country, and where reimbursements should be or already have been requested – or not, as the case may be. And they are often unaware of which expenses are even reimbursable or are unable to systematically document them. Invoices or reimbursement requests submitted too early, too late or to the wrong authority allow existentially crucial cash to simply evaporate and therefore have a significant impact on liquidity.

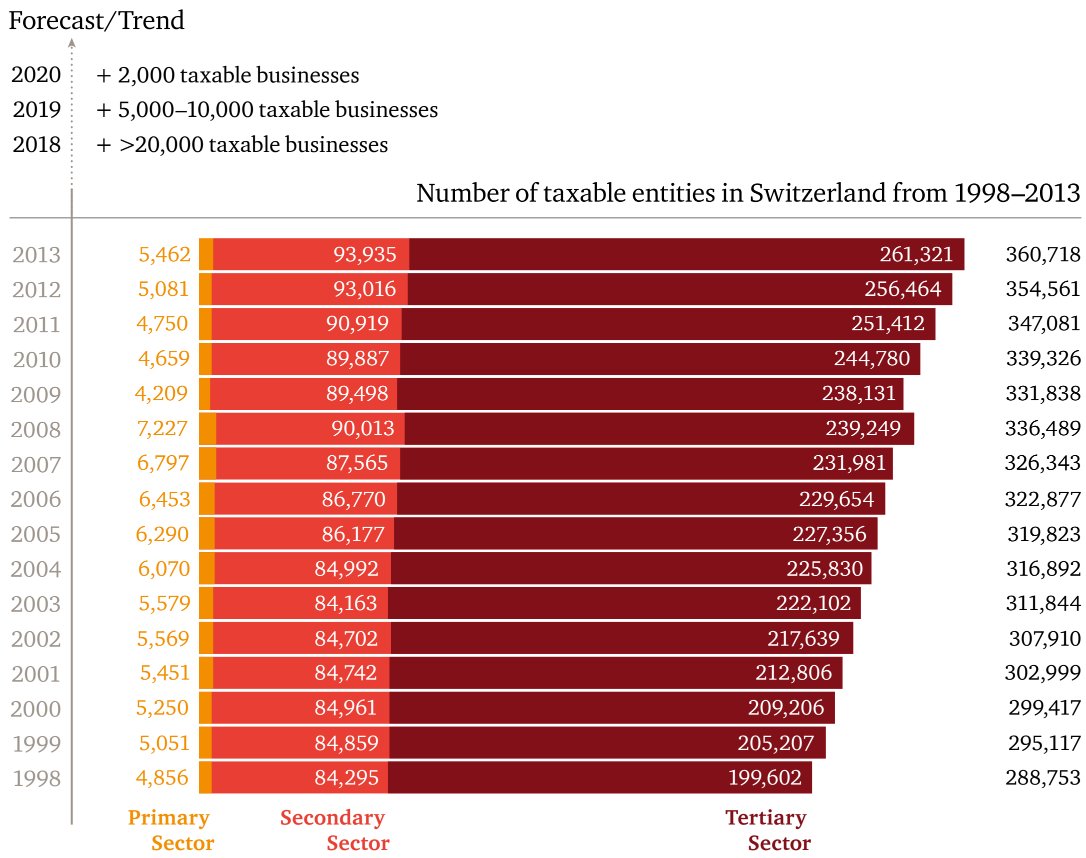


Figure 3: The number of taxable entities in Switzerland from 1998 to 2013 (source: FTA) and the anticipated trend through 2017 (source: PwC)

OUR TAKEAWAY

Cash flow can only be steered effectively if people understand where and at which intervals VAT is incurred, as well as when the related reimbursements will be received. A sustainable approach to VAT compliance helps to identify and avoid potential losses by signaling the need to adapt current processes. A well-developed VAT application prevents double payments and ensures booked VAT is also declared in the tax period in which it is still recoverable. Thus, the company can filter invoices according to foreign VAT payments and initiate the reimbursement process in good time. The combination of these measures helps to optimise net cash flow and deploy this liquidity in a way which fulfils its intended purpose, namely cost- effective internal financing.

"VAT regulation is an important competitive factor for us."

Romana Giesen,
Head of Group Taxes,
Swisscom AG

Partial revision of the VAT Act

Switzerland's partially revised VAT Act (VATA) is scheduled to enter into force on 1 January 2018. A central element of this new legislation is the elimination of VAT-related disadvantages domestic companies have had to bear compared to their foreign competitors. Going forward, each business entity will become liable in Switzerland for VAT as of its first Swiss franc of revenue, provided that the entity generates worldwide sales of at least CHF 100,000. This will boost today's total of roughly 366,000 taxable entities by an estimated additional 30,000. On balance, the proposed legislation will lead to an annual increase in VAT revenues of about CHF 68 million. The greatest financial effects will come from the redefinition of the tax obligation, which should result in added revenues of some 40 million francs.

Please note: Similar law changes are being considered in other countries. So Swiss companies could also soon be affected by those harsher foreign provisions. This makes it all the more important to have a VAT compliance routine in place that takes into account the peculiarities of every counterparty country.

THESIS

4

Systematic analyses uncover irregularities in transaction data and help avoid costly penalties.

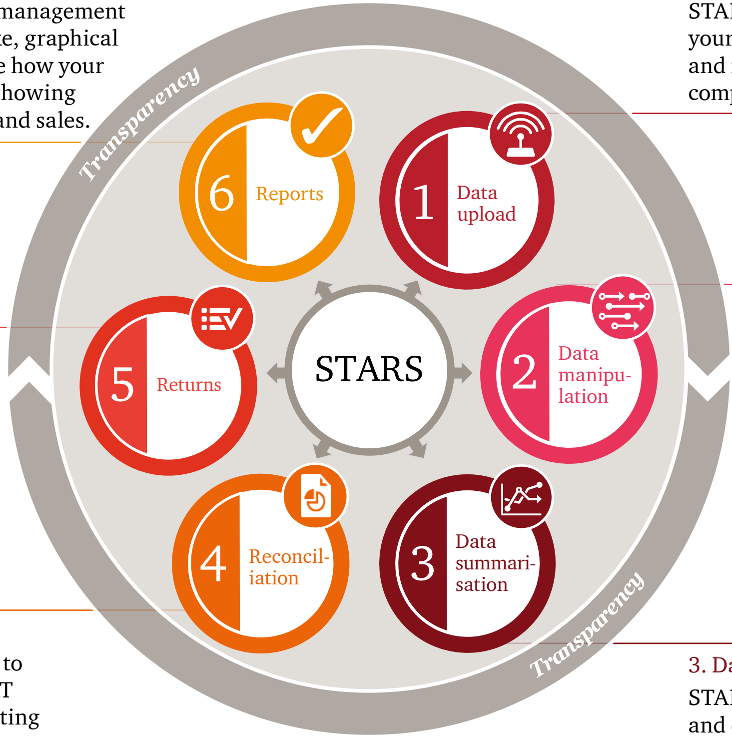
The facts

At larger companies, no one can really maintain a complete overview of the countless business transactions – the number of influencing factors is simply too vast. All too often, invoices are paid twice, processed with incorrect exchange rates or assigned improper customs tariff codes. Cases like these are an everyday occurrence and cannot be ruled out even with the best people or the most rigorous random sampling.

Errors or deficiencies of this kind not only have a direct financial impact, they also harbour an additional risk: if they are discovered by a tax authority, the company – depending on its past trustworthiness and the practice of the given tax authority – stands to be penalised in the form of interest claims, fines, assessments or even the imprisonment of those responsible. In certain instances, measures like these can place a company in financial difficulty, not to mention do enormous harm to its reputation.

6. Reports:
STARS creates valuable management information with bespoke, graphical reporting to demonstrate how your business is performing, showing the profile of purchases and sales.

1. Data management (upload):
STARS takes data straight from your ERP and other systems and maps it to its testing and compliance functionality.



2. Data analysis (manipulation):
STARS reviews uploaded data using built-in tests, with a dashboard visualising risk areas to help you improve processes and reduce future errors.

5. Returns:
STARS manages your in-country reporting obligations.

4. Reconciliation:
STARS saves you having to manually match your VAT reporting data to accounting posting.

3. Data summarisation:
STARS gets into the detail quickly and displays any transaction type, customer or supplier you want to review.

Figure 4: VAT compliance technology like STARS helps drive efficiencies and lower risk.

OUR TAKEAWAY

Good VAT compliance begins right at the outset of the VAT process and is based on intelligent, recurring data analyses. The latter asses all transaction data in keeping with predefined algorithms and seek out irregularities in the recording of incoming and outgoing business transactions. For example, cleverly conceived software notices immediately when datasets fail to match. Some applications signal a warning if a specific type of transaction is suddenly handled differently to before. This way, errors can be identified and remedied promptly, and serious penalties can be avoided. The rule of thumb in this regard: the savings afforded by timely identification of errors far outweigh the added cost for electronic testing. And yet another favourable side effect from systematic data analyses: the company achieves clarity on the accesses to and any potential encroachments of its data, thereby automatically improving the quality of that data.

“The state depends on companies fulfilling their VAT mandate reliably.”

Julia Sailer,
Leader VAT Compliance,
PwC Switzerland

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