



# Direct to indirect taxation

## Managing the hidden complexities of indirect taxation

From pricing and reputational risks to the threat of systems overload and cash flow disruption, indirect taxation is nothing like as easy as it seems. Almost everything that makes value-added tax (VAT) and goods and services tax (GST) attractive to governments can make it a headache for businesses.

One of the main reasons why VAT/GST tend to be easier for tax authorities to apply and police is that a lot of the legwork and complexity are passed on to businesses. As the Grant Thornton global International Indirect tax guide<sup>1</sup> of over 120 countries highlights, dealing with GST or VAT and their knock-on impacts can therefore be a significant challenge.

And as indirect tax is used to help bring e-commerce imports into a taxable net that is both virtual and physical, indirect tax is providing the catalyst for moves to real-time tax reporting, audit and collection. As such, the ramifications go far beyond either sales or countries that apply VAT or GST. Some of the biggest challenges are faced by mid-sized multinational enterprises (MNEs) that may lack the resources and infrastructure to meet these complex demands.

So why is indirect taxation more complicated than it looks and what risks does it open up? How can your business get to grips with implementation, management and control challenges?

<sup>1</sup> [International indirect tax guide 2018](#)



# Competition, simplification and resistance: Why indirect tax is in the spotlight

Indirect taxation has become the favoured fiscal option for many governments worldwide. General consumption taxes, including VAT, GST and sales taxes, now account for more than 20.8% of total tax revenue on average in the OECD, compared to 13.4% in 1975. VAT is by far the largest part of this.<sup>2</sup>

Why has indirect taxation become so popular? Compared to direct taxation (eg corporate and personal income tax), indirect taxes are generally cheaper for tax authorities to collect and easier to police. Indirect taxes pass a lot of the burden of tax evaluation on to companies by attaching themselves to multiple transactions rather than their outcomes (eg income and expenditure). VAT, GST and sales taxes also allow tax authorities to apply a flat rate tax, albeit with the complication of minimal turnover thresholds for businesses and exemptions for certain goods and services. Further impetus has come from the competition to attract MNEs into local markets, with increases in indirect taxation giving scope to cut headline corporate tax rates.

## Introducing the Netflix tax

While these benefits have always been there, the overwhelming argument for an increasing number of policymakers is the opportunity to use indirect taxation as an effective way to tax digital imports and other aspects of the virtual economy. At present, e-commerce and broadcasting companies can sell products, services and content in a particular jurisdiction without a traditional physical taxable presence.

Applying taxes at the point of consumption (a destination tax) rather than the point of origin or production enables tax authorities to reclaim the 'lost' revenue. Leveling the playing field for businesses with a traditional taxable presence.<sup>3</sup>

Australia is one of the countries to have applied this so-called 'Netflix tax'. Foreign businesses are liable for a flat rate GST of 10% on imported services and digital products supplied to Australian consumers. Also poised to follow suit are:

- **Malaysia** – through a proposed tax on imported business-to-business (B2B) services from 1 January 2019 and a similar business-to-consumer (B2C) levy from 1 January 2020.
- **Canada** – the province of Quebec has its own Netflix tax obligations on non-resident organisations making supplies of services or intangibles to consumers and non-registered businesses, effective from 1 January 2019.

In Singapore, tax authorities are planning to require overseas vendor registration as part of their moves to bring imported e-commerce into the tax net. With the OECD's Base Erosion Profit Shifting (BEPS) Action Plan endorsing the destination tax principle, many more countries look likely to adopt this approach.

## Increasing the take

While a lot of the focus is on new applications of VAT/GST (eg the introduction of VAT in the Gulf Cooperation Council states), just as significant are increasing rates and penalties within many countries and the administrative obligations in many jurisdictions. As our Grant Thornton global International Indirect tax guide highlights,<sup>4</sup> Tax authorities are also removing exemptions (eg fuel in the Philippines) and tightening up rules (eg changes to holding corporation regulations in Canada).<sup>5</sup>

## Popular and political pushback

However, growing popular resentment and resulting political pushback in a number of countries shows that support for VAT/GST is far from universal.

Many consumers dislike the rise in prices from VAT/GST and the fact that the money they pay in tax is largely hidden. As VAT/GST is considered regressive in nature, the burden can fall heaviest as a proportion of income on the most disadvantaged people. Exemptions on basics such as food, fuel, clothing and medicines can help to alleviate this. But they make tax systems more complex.

<sup>2</sup> [www.read.oecd-ilibrary.org](http://www.read.oecd-ilibrary.org) – Consumption tax trends 2018.

<sup>3</sup> [www.grantthornton.global](http://www.grantthornton.global) – Taxing the digital economy, September 2018.

<sup>4</sup> [International indirect tax guide 2018](#)

<sup>5</sup> [www.fin.gc.ca](http://www.fin.gc.ca) – Department of Finance Canada, Consultation Concerning the GST/HST Holding Corporation Rules, September 2018.

The potential backlash is highlighted by the new Malaysian government's repeal of GST barely four years after its introduction. The older single-stage sales tax and services tax were reintroduced as replacements, though revenues are expected to be only around a half of those generated by the GST.<sup>6</sup>

### Implications

- 1 Rising prices from charging VAT/GST could dent demand, though sales taxes have a potentially higher impact on prices as sellers can't reclaim the taxes they pay to suppliers. In Malaysia, the reintroduction of sales tax to replace GST in September 2018 has been unpopular with some businesses. To address this, the 2019 Budget, which was tabled on 2 November 2018, includes the proposed introduction of a new credit system for sales tax and B2B service tax exemption, which are due to take effect from January 2019.
- 2 Risk of double taxation as some territories continue to apply tax at point of production and others at consumption.
- 3 Risk of being caught up in Netflix tax trawl and requirement for new registration adding significantly to compliance costs and risks of not conforming with misunderstood regimes. The risks were illustrated when Australia removed its Low Value Threshold for importation of goods, netting many e-retailers that otherwise wouldn't be caught for GST/VAT purposes.  
The broadening in the registration net is highlighted by the US Supreme Court's landmark South Dakota versus Wayfair ruling.<sup>7</sup> This overturned the physical presence requirement for state sales and use tax purposes. The ruling is shifting the balance around corporate taxation in the US. There is a high possibility that this will start a trend toward more robust transaction taxes and increasingly aggressive state and local enforcement, with an array of exemptions and credits to navigate.
- 4 Unpopularity of VAT/GST creates significant reputational risks. This includes the risk of being seen to take advantage of exemptions or no physical presence/permanent establishment (PE) designation. There is also a danger of being seen to be profiteering by applying VAT/GST, but not reflecting reductions in other taxation in pricing.

### Actions

- 1 Engage with tax authorities to reduce risk of double taxation.
- 2 Determine whether tax and PE status of digital operations are still valid as a result of current and incoming Netflix style tax changes. Your business may need to register in some new jurisdictions as a result and address issues relating to tax compliance and management. It's important to get on the front foot and manage changes in a cost-efficient way. The big risks and costs would stem from being caught on the back foot and having to respond without adequate planning and preparation.
- 3 It's important to engage with tax authorities over a sensible redefinition of a PE that reflects the realities of modern digital commerce, without being needlessly punitive, arbitrarily applied or commercially distortive.
- 4 Identify and manage reputational risks. This includes engaging with customers and applying new or rising taxes sensitively through steps such as phased increases. It's important to take account of the potential backlash that could stem from appearing to profit or using complex structures to engineer exemptions.

### Is corporate tax dead?

Many governments are looking to bring down corporate tax rates to boost investment and help attract new businesses into their markets. The US has slashed its corporate tax rate from 35% to 21%. Many major markets, such as the UK, now have even lower corporate tax rates.

Could corporate taxation be on the way out altogether? Is indirect taxation picking up the slack?

Corporate tax revenues were severely depleted by the global financial crisis and are still below their pre-crisis levels (9% of total tax revenue in the OECD in 2016 compared to 11.1% in 2007).<sup>8</sup> By contrast, VAT revenues in the OECD hit an all-time high of 6.8% of GDP and 20.2% of total tax revenue on average in 2016.

Yet, we shouldn't mark the end of corporate tax quite yet. Politicians are deeply sensitive to public concerns over perceived underpayment of tax by corporations. And corporate tax is of course only one part of what they pay. Businesses make huge, and in some countries, higher payments into the public purse through employers' social security contributions.<sup>9</sup> In turn, potential public resentment over VAT/GST means that it may be curbed or not applied at all in some markets.

Therefore, while there may be a continued shift away from direct corporate tax to indirect alternatives, the main impact will be heightening an already complex, uncertain and difficult to manage tax landscape.

<sup>6</sup> [www.bloomberg.com](http://www.bloomberg.com) - Here's how scrapping Malaysian consumption tax will play out, May 2018.

<sup>7</sup> [www.grantthornton.global](http://www.grantthornton.global) - Wayfair ruling

<sup>8</sup> [www.oecd.org](http://www.oecd.org) - Tax revenues continue increasing as the tax mix shifts further towards corporate and consumption taxes - 5 December 2018.

<sup>9</sup> [www.oecd.org](http://www.oecd.org) - Employer social security contribution rates.

# Cutting through the complexities: Managing transition and change

While businesses can't reclaim sales taxes, VAT/GST are harder to implement and manage given the multi-stage nature of the VAT/GST.

Unlike a sales tax, VAT/GST is levied on the difference between the purchase and the resale price – the 'value add'. As such, businesses can generally reclaim as well as pay tax, and therefore the net result should in theory be to tax just the profit on the supply of goods and services. In practice, this is not the case as labour and payroll costs generally do not attract GST/VAT and the tax systems impose significant operational costs and risk of error. This includes collating and reporting multiple supply data. The challenges are compounded by the fact that implementation and changes in VAT/GST are now routinely being used as the catalyst for moves to digitise real-time tax reporting, audit and collection.

There is also a lag between paying and reclaiming tax, which can stretch out for months and even in some cases years. In Malaysia, the controversy over GST has been heightened by the new administration's disclosure that the previous government had not paid out around RM19 billion in GST refunds accumulated since 2015.<sup>10</sup> The complexities of managing payment and claiming refunds are heightened by multiple and not always clear exemptions.

“The challenges are compounded by the fact that implementation and changes in VAT/GST are now routinely being used as the catalyst for moves to digitise real-time tax reporting, audit and collection.”

<sup>10</sup> [www.thestar.com.my](http://www.thestar.com.my) – 2018 Budget Speech by Minister of Finance Lim Guan Eng, 2 November 2018.

“The big danger is regarding VAT/GST as simply a sales tax or as a fairly straightforward change, which only affects the tax and wider finance teams.”

### Implications

- 1 Clearly, some prices will rise with any new indirect system. But companies often under-estimate the additional impact of higher systems and compliance costs. A key question is how to remain price competitive under the new system.
- 2 Implementation demands are often under-estimated, leading to under-resourcing and inadequate preparation time. The big danger is regarding VAT/GST as simply a sales tax or as a fairly straightforward change, which only affects the tax and wider finance teams. In reality, there are multiple issues and complexities to consider and address across the organisation, including sales, marketing and public relations.
- 3 Delays in reclaiming tax can lead to significant cash flow problems. These can be exacerbated by poor or slow identification of reclaimable payments to suppliers.

### Actions

- 1 Take time to understand VAT/GST legislation and expectations and prepare an impact analysis. Key priorities include supply chain mapping. It's also important to work out how to make sure accurate recovery of input tax and accounting of output tax across what could be extended supply and distribution chains.
- 2 Consider cash flow impact – at times refunds may be delayed but remittance of tax must be made, even if the customer has not yet paid the tax.
- 3 Look at VAT/GST as part of total tax evaluation – where are you losing, where are you gaining and how can this be balanced?
- 4 Gather input from commercial teams. This includes assessing the impact on pricing and market reputation. Clear understanding and early planning can allow time to identify and, where possible, capitalise on opportunities for differentiation. Possibilities include passing on savings on other forms of taxation to consumers.
- 5 Build VAT/GST into a wider review of whether current tax management is fit for purpose and overall plans for system modernisation and management. Is your business equipped for real-time tax management – culturally and reputationally as well as operationally?

“ Our work with clients has highlighted the planning, time and organisation-wide co-ordination needed to be set up and manage compliant accounting, as well as the IT systems used for VAT.”

### Getting ready: Spotlight on Bahrain

From 1 January 2019, businesses in Bahrain will need to apply 5% VAT on most goods and services. There are proposals to exempt medicines, education and certain food stuffs.

VAT will be levied on the landed cost of imported goods through a Reverse Charge Mechanism (RCM), similar to the one applied in the EU, under which the customer is responsible for accounting for VAT on the supplied goods.

Funding of public services in Bahrain has traditionally been reliant on oil and gas revenues, with low taxation and limited compliance demands on businesses. The introduction of VAT is therefore a significant operational challenge and steep learning curve for businesses in the Kingdom.

Our work with clients has highlighted the planning, time and organisation-wide co-ordination needed to be set up and manage compliant accounting, as well as the IT systems used for VAT. The challenges are heightened by complexities in areas ranging from import and export to related party transactions and also place of supply within the Gulf Cooperation Council region.

Many businesses have found that their existing accounting systems don't provide the necessary information for supply and sales taxes and have therefore needed to be upgraded. Some have also under-estimated the importance of strategic direction from the board and need for organisation-wide understanding and involvement.

Early impact analysis would enable issues to be addressed with enough time to minimise deficiencies ahead of a go-live date. Even if details of regulations aren't finalised – in Bahrain the enacting Royal Decree was released in October 2018, just months ahead of go-live – a lot of the preliminary work can be completed on an 80:20 basis.

The strategic assessment should look closely at systems demands as time needs to be allowed for selection, installation, training and testing. A key part of this is matching compliance, filing and management information requirements with vendor specifications. With real-time tax demands on the horizon, it's also important to make sure systems are fit for the future.

### Managing the system: Update on United Arab Emirates

The introduction of VAT in the United Arab Emirates (UAE) at the beginning of 2018 has been a transformational shift for businesses and the economy.

Previously, companies did not have to deal with any major form of indirect taxation other than customs duties on imports. Now they've had to adapt or upgrade IT and accounting systems, issue valid tax invoices to collect the 5% VAT payments from customers, and file VAT returns.

Nearly a year in, the implementation and operational management challenges persist, with the Federal Tax Authority (FTA) taking a hard line on compliance and the resulting imposition of penalties.

The FTA has aided tax payers by issuing new guidelines to help provide greater clarity around areas of uncertainty and potential dispute. Yet, difficulties remain. In the insurance sector, for example, there is still potential disagreement and dispute between suppliers and customers over whether the VAT liability on certain services should be exempt or zero-rated. Therefore, there is still the need to undertake a review of existing VAT positions based on clarifications issued by FTA and, where necessary, rectify incorrect positions and previous VAT returns.

With the FTA expected to commence VAT audits in the first quarter of 2019, further priorities include conducting a health check of all VAT returns submitted and rectify any errors made in previous returns or notify the FTA by way of a formal disclosure.

# Conclusion

It's not just the immediate demands of VAT/GST that are complex and challenging, but the extent to which it forms part of wider shifts in how businesses are taxed (production to consumption), where they're taxed (new definitions of PE) and how they engage with tax authorities (real-time tax).

Rather than looking at indirect taxation in isolation, it's therefore important to look at how it fits into the wider future of tax, systems modernisation and engagement with tax authorities.

VAT/GST is an issue of cost-competitiveness rather than just compliance. Sales, marketing, HR, legal and procurement all need to be aware and actively participating in a shift that affects multiple parts of the business, some aspects of which won't be evident until there is an organisation-wide impact assessment.

The better prepared your business is, the bigger the opportunity. If you're not sufficiently aware, mobilised and strategically and operationally ready to go-live, the bigger the risks of adverse profit and loss impacts, non-compliance, tax investigation, reputational damage and cash flow problems.

If you would like to discuss any of the areas raised, please contact your local Grant Thornton advisor or one of the contacts listed.

## Australia

Tony Windle  
E [tony.windle@au.gt.com](mailto:tony.windle@au.gt.com)

## Bahamas

Kendrick Christie  
E [kchristie@bs.gt.com](mailto:kchristie@bs.gt.com)

## Bahrain

Jatin Karia  
E [jatin.karia@bh.gt.com](mailto:jatin.karia@bh.gt.com)

## Canada

Christina Zurowski  
E [christina.zurowski@ca.gt.com](mailto:christina.zurowski@ca.gt.com)

## India

Suresh Nandlal Rohira  
E [suresh.rohira@in.gt.com](mailto:suresh.rohira@in.gt.com)

## Ireland

Jarlath O'Keefe  
E [jarlath.okeefe@ie.gt.com](mailto:jarlath.okeefe@ie.gt.com)

## Malaysia

Alan Chung  
E [alan.chung@my.gt.com](mailto:alan.chung@my.gt.com)

## Philippines

Lea Roque  
E [lea.roque@ph.gt.com](mailto:lea.roque@ph.gt.com)

## Singapore

Lorraine Parkin  
E [lorraine.parkin@sg.gt.com](mailto:lorraine.parkin@sg.gt.com)

## UAE

Steve Kitching  
E [steve.kitching@ae.gt.com](mailto:steve.kitching@ae.gt.com)

## United Kingdom

Alex Baulf  
E [alex.baulf@uk.gt.com](mailto:alex.baulf@uk.gt.com)



**Grant Thornton**

**An instinct for growth™**

---

**grantthornton.global**

© 2018 Grant Thornton International Ltd. All rights reserved.

'Grant Thornton' refers to the brand under which the Grant Thornton member firms provide assurance, tax and advisory services to their clients and/or refers to one or more member firms, as the context requires. Grant Thornton International Ltd (GTIL) and the member firms are not a worldwide partnership. GTIL and each member firm is a separate legal entity. Services are delivered by the member firms. GTIL does not provide services to clients. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions.