Rethinking tax: The shift to indirect tax

The global tax landscape is going through a period of fundamental change. Governments are now rethinking how taxes are levied. Changes have been triggered by the rapid spread of technology, new supply chains, debt pressures, and an increased scrutiny of multinational tax practices. More than ever, tax is a top priority for businesses, as sweeping changes, brought in through the Organisation for Economic Cooperation and Development’s (OECD’s) Base Erosion and Profit Shifting (BEPS) recommendations, transform the way they operate.

Whilst corporate tax avoidance continues to grab headlines, some of the biggest reforms are in fact occurring within indirect tax. This year, two of the world’s most populous countries – China and India – are expected to transform their indirect tax systems. China is set to complete the final stage of its Value Added Tax (VAT) reform, whilst India is expected to introduce its long-awaited comprehensive Goods and Services Tax (GST) system. Just next door, Bangladesh has plans to implement a new VAT in July. The Middle East are also expecting momentous changes. In a move to generate additional revenue and diversify the economy, the Gulf Cooperation Council (GCC) countries – Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain, and Oman – are expected to levy VAT from 2018.
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These upcoming changes are all off the back of Malaysia’s successful GST regime introduction on 1 April 2015 and Puerto Rico, where VAT is scheduled to go live on 1 April 2016. Puerto Rico’s adoption is particularly momentous as it will bring VAT close to the United States’ shores – the only member of the OECD which does not have a VAT system. Indeed, even The Bahamas, traditionally seen as a ‘tax haven’, introduced VAT in 2015.

Whilst some will dismiss the rise of indirect taxes as a simple tax grab, there are underlying reasons behind this trend. This article explores the primary reasons behind the global shift to indirect tax.

The shift to indirect tax will transform the way businesses operate within these countries.

You will need to start thinking about the various financial and operational implications that VAT implementation may have and what to do to prepare for them. You will most likely need to:

- Review your indirect tax risk procedures/develop an effective VAT risk management framework
- Understand VAT registration requirements and thresholds
- Undertake contract reviews to ensure appropriate VAT/GST clauses are properly included
- Review supply chains to ensure that any VAT/ GST leakage is identified and managed
- Make sure the VAT function is in the hands of personnel adequately trained in VAT compliance
- Make sure Enterprise Resource Planning (ERP) systems are up to date and can cope with complex transaction processes.

Countries transforming their indirect tax regimes or introducing VAT/GST

Puerto Rico

China

India

Bangladesh

Kuwait

Bahrain

Qatar

UAE

Saudi Arabia

Oman

Bahrain
Defining indirect tax

Indirect tax is increasingly becoming the new direct tax. More than ever, governments are relying upon indirect taxes to generate tax revenue. Today, VAT – the most popular form of indirect tax – raises approximately 20% of worldwide tax revenues, and the number is growing. The shift to indirect tax is transforming the way we view taxation itself. Taxation is no longer just about profits, income and wealth. It is about transactions, production and distribution.

Why the change?

Revenue raising

VAT raises substantial amounts of revenue for governments. The numbers are staggering. On average it accounts for 6.6% of Gross Domestic Product (GDP) amongst OECD countries, whilst in the European Union (EU), it is around 7.5% of GDP amongst Member States.

Snapshot: GCC countries

The GCC members have relied heavily on the oil and gas sector to promote economic growth. In the last decade, hydrocarbons represented almost 90% of budget revenues for most GCC members. The introduction of VAT in the region will enable the GCC members to raise revenue, diversify their economies, and reduce reliance on oil and gas in the future. The United Arab Emirates (UAE) is expected to raise between AED 10 billion and AED 12 billion in revenue in the first year of implementation, whilst Saudi Arabia is expected to accumulate SR 35 billion (1.2% of GDP).

Indirect taxes can be defined as a class of taxes which are not solely levied directly on the person who bears the ultimate economic burden of the tax. VAT – is a multi-stage tax levied on the ‘value added’ to goods as they pass through the various stages of production and distribution and to services as they are performed. VAT is a tax on consumption, not business, meaning the ultimate cost of the VAT will usually be borne by the final customers. Whilst VAT is generally considered a ‘wash-through’ tax or ‘neutral’ to most businesses, it should not assume a lower priority in a company’s tax function. It is the business that ultimately carries the risk of non-compliance. A business acts as an unpaid collector of the tax on behalf of tax authorities, and can receive assessments, penalties and interest for under-collected VAT, or incorrect input tax credits taken.

“Although, the date of introducing value added tax (VAT) has not yet been confirmed, the GCC states have moved one step closer to fiscal reform. It has been said that within the next three years, all nations in the GCC will be implementing VAT, which will inevitably bring change. The committee has confirmed that there will be an 18 to 24 month grace period with zero tax on healthcare, education and social services, with 94 food items said to be exempt from tax. The bilateral move towards fiscal reform would help generate additional government income and further strengthen the economy for generations to come.”

Hisham Farouk, CEO, Grant Thornton, United Arab Emirates

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The growth friendly tax choice
VAT is often described as a ‘growth-friendly’ and ‘efficient’ tax. According to the International Monetary Fund (IMF), broad-based consumption taxes have the advantage of not discouraging saving and investment decisions.6

The IMF, in contrast, states that corporate income taxes tend to discourage two of the most important contributing factors to business growth: capital investment and productivity improvement.7

Other studies have shown that corporate income taxes can reduce foreign direct investment.8

Growth in the digital economy
Globally, governments have increasingly sought to tax the ever growing digital economy where consumption takes place. This has not only been fuelled by a need to raise more revenue, but also to ‘level the playing field’ between resident and non-resident supplies of digital services. Although this trend first started in 2003 when the EU bought in specific rules to tax non-resident supplies, today the list of countries with similar legislation is growing, eg South Africa, South Korea, Norway and Japan.

The Australian government has recently introduced measures seeking to address the revenue ‘gap’ that is occurring from the growth in the digital economy by consumers. The proposed amendments to the GST provisions will result in offshore suppliers of digital or intangible services charging and collecting GST on services provided to Australian consumers from July 2017.

Race to the bottom
Corporate income tax rates have declined dramatically over the last two decades. In the early 1980s, the average rate amongst OECD countries was 47.5%.9 Today, the average rate has almost been halved.

A major reason behind the dramatic decline is the so-called ‘race to the bottom’ phenomenon. In order to attract the inward flow of capital and mobile profit from multinational corporations, countries compete with each other by making their tax systems more attractive, which generally involves reducing their corporate income tax rates.

Whilst the inward flow of capital has a positive impact on a country’s economy, the decline in corporate income tax rates obviously has a negative impact on the government’s tax revenues. In order to close this gaping hole, governments have shifted their attention to consumption taxes, particularly VAT.

Europe
The shift to indirect tax may escalate in Europe. Currently, the European Commission is pushing for a Common Consolidated Corporate Tax Base (CCCTB) regime. Under the proposal, European corporations would be required to calculate their tax liabilities by reference to a single set of rules. Relevantly, Member States will continue to have the freedom to set their own corporate income tax rates. The proposed CCCTB regime could ultimately trigger lower corporate tax rates as Member States would compete to counter homogenous tax rules. This could potentially result in a greater emphasis on VAT in the region as Member States would seek to replace ‘lost’ corporate tax revenues.

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6 International Monetary Fund, ‘Growth-Friendly Fiscal Policy’.
7 Ibid.
Out with the old, in with the new
Not all indirect taxes are ‘efficient’ and ‘growth-friendly’. Various forms of indirect taxation can lead to revenue leakages, economic inefficiency, and double taxation. A major reason behind the current shift to GST in India and VAT in China is to eliminate these issues.

India
Current framework
In India, taxes are currently multi-layered. At national level, the central government levies various forms of indirect tax, including excise duty (CENVAT) (to be confirmed), central sales tax, and service tax. At state level, the state government levies VAT, state excise, and entry tax, amongst others.

Why?
The Indian government has justified the introduction of a GST system on the basis that it will remove the burden of ‘tax on tax’ prevalent at both the Central and State level.

Status
The ‘GST Bill’ has been passed by the lower house of Parliament and the government will be eager to ensure passage through the upper house in early 2016. The anticipated implementation of April 2016 seems likely to become 2017.

China
Current framework
Since 1994 two major indirect tax systems have coexisted in China. Business Tax (BT) is imposed by local governments on the provision of most services and the transfer of intangible assets and real property. China’s VAT is levied by the central government on the sale and import of tangible goods and the provision of processing, repair, and replacement services.

Why?
On 1 January 2012 a pilot programme was introduced in China to replace BT with VAT for certain industries and sectors. The pilot programme was the start of a process to replace the existing dual indirect tax system and apply VAT to all goods and service sectors. Under the existing BT regime, a business cannot claim an offset for VAT incurred, thus resulting in double taxation; the government has pursued indirect tax reforms in order to eliminate this inefficient effect.

Status
The financial services, insurance, real estate/construction and hospitality services are yet to transition to the VAT. It was recently announced that these services will move to VAT on 1 May 2016. Generally the regulations are released near the start date. Therefore, businesses should look out for updates and make preparations.

Puerto Rico
Current framework
Sales and Use Tax (SUT) is the principal indirect tax in Puerto Rico. It is a tax on sales and use of taxable personal tangible property and services to the final consumer based on sales price.

Why?
VAT is being introduced as part of a wider tax reform package in an effort to address the ongoing debt crisis in the country.

Status
VAT is scheduled to go live on 1 April 2016 at a rate of 10.5%. Clear guidance on fiscal statements requirements and how the credits under the VAT regime will work have not yet been published by the Puerto Rican Treasury Department. Businesses need to watch for updates.
Changes are happening for a number of reasons and governments are shifting their focus to indirect taxes. With significant changes occurring in the area of indirect taxation, you and your business need to actively monitor for updates and prepare accordingly when operating or expanding overseas. Our next article ‘Let’s be clear – indirect tax is a business issue’ looks in more detail at tackling the commercial and operational challenges of indirect taxation.

If you would like to talk about any of the points raised in this article please speak to one of the contacts listed or your usual Grant Thornton contact.

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