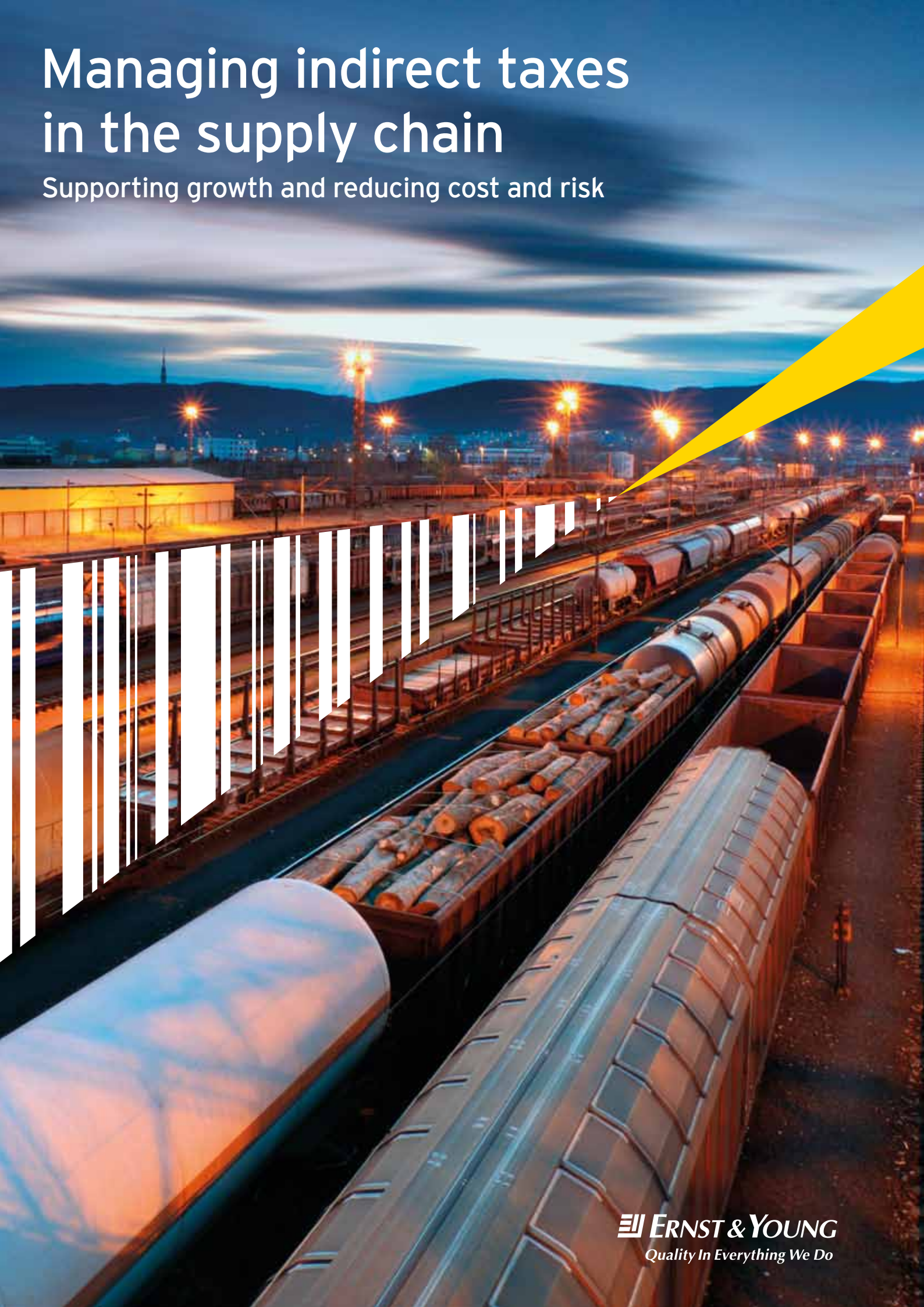


Managing indirect taxes in the supply chain

Supporting growth and reducing cost and risk





Welcome

Globalization is changing how we do business in every industry and in every part of the world. Global companies are rapidly transforming their supply chains to go wherever necessary to reduce costs, launch products and enter lucrative new markets. Operating in this complex global environment presents a range of challenges for indirect taxes such as value added tax (VAT), goods and services tax (GST), customs and excise duties, environmental duties, grants and incentives. Confronting those challenges and finding effective solutions will continue to be crucial as the business landscape continues to change.

In this report, *Managing indirect taxes in the supply chain: supporting growth and reducing cost and risk* we look at the indirect tax supply chain issues that multinationals face when operating in a complex, changing world. We also examine how they tackle these issues in practice, drawing on some of the lessons they have learned and the “leading practices” they have developed.

This report is primarily aimed at the people responsible for tax and financial reporting in multinational organizations. But we hope tax and financial executives will also use it to start, and contribute to, wider discussions throughout the organization about how best to manage the global supply chain. Our comments and insights are chiefly based on the experience of our global networks of Indirect Tax and Incentives professionals and on in-depth interviews conducted with in-house tax executives at a number of global companies (operating in more than 30 countries worldwide).

We hope you find this report interesting and the insights and examples provided useful information for your business. We would welcome the opportunity to discuss these topics with you in more detail. If you would like to explore how we may assist you to improve the management of indirect taxes for your multinational organization, please contact one of the Indirect Tax leaders listed at the end of this report or your usual Ernst & Young Indirect Tax contact.

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Executive summary

What we are seeing around the world

In recent years, a combination of world events, the global economic crisis and rapid advances in technology have wrought radical changes in international trade. Few global companies today do business in the same way or in the same places as they did even five years ago. They are extending their reach into new markets and seeking to thrive in developed economies by operating more effectively and efficiently. These developments are having profound effects on global supply chains – changing how and where materials and products are sourced, manufactured, distributed and sold.

Indirect taxes – such as VAT/GST, customs and excise duties – are typically based on trade flows and transactions, not on profits or income. As such, they are inextricably linked to supply chain activities. Changes in the ways companies are doing business are having a profound impact on these taxes. Equally, changes in these taxes may have a profound effect on companies' supply chains, influencing where activities are carried out, the cost of finished products and delivery routes and timing. Increasingly, companies recognize that effective management of indirect taxes, grants and incentives is essential to support growth and reduce the costs and risks of doing business internationally.

The changing supply chain

World trade patterns are changing

At the start of the 1990s, global trade was dominated by the developed nations; by 2010, the advanced economies accounted for a little more than 60% of global merchandise exports. New markets are opening, companies are exporting to more countries than ever before and trade routes are changing. China is now the biggest trading partner for Australia, Japan, South Korea, India, Russia and South Africa and is increasing its share of trade with Europe and the US. As the current emerging economies (such as Brazil, Russia, India and China) grow and mature, new developing economies are likely to emerge (such as Vietnam and Cambodia).

Supply chains are transforming

In response to these changing patterns in global trade, companies are rapidly transforming their supply chains to go wherever necessary to support growth and reduce costs and risks. For many companies, supply chain activities – such as product engineering, sourcing, manufacturing and logistics – are now widely dispersed around the world. As activities are outsourced, centralized and streamlined to gain efficiencies and maximize scarce resources, corporate structures and functions are also being transformed.

Indirect taxes in the supply chain

Changing global supply chains challenge indirect taxes

Changes in world trade and in supply chain models present challenges for indirect taxes (including taxes on consumption such as VAT/GST and sales taxes, customs duties and environmental taxes, as well as grants and incentives) and excise duties. Because supply chain transformations are intended to obtain operational and financial benefits, indirect tax considerations may not be at the forefront of the decision – despite the fact that indirect tax treatment of transactions, the company's compliance obligations and the customs regimes and incentives that are available may be seriously different as a result of any change.

Changing indirect taxes challenge global supply chains

Governments around the world are increasingly relying on indirect taxes to bolster revenues and fund tax reforms in other areas. Global companies need to be aware of the main trends in indirect taxation and their impact not only on supply chain transformations but also on their existing supply chains.

Broadly, recent changes include: increasing tax rates for VAT/GST and excise taxes; the adoption of new taxes as emerging markets introduce VAT/GST and developed markets introduce new excise and "green" taxes to influence consumer behavior and protect the environment; a reduction in customs duties through new Free Trade and Preferential Trade

agreements; and an increasing range of tax incentives and grants aimed at stimulating job creation, particularly higher-value, high-wage activities and non polluting industries.

Companies should also be aware of the growing emphasis by tax authorities on full compliance with indirect tax obligations. Increasingly, they are turning to advance technologies for reporting obligations, to collect information and to audit companies' activities. Although a growing number of countries are imposing requirements on companies to submit electronic data, there is still little harmonization of indirect tax reporting requirements in different jurisdictions, adding to global companies' compliance obligations and the risk of making errors.

Meeting indirect tax challenges in the supply chain

Effective management of indirect taxes is essential to support growth and reduce costs and risk. If these taxes are left out of the picture, the expected benefits of a supply chain transformation may not be fully maximized or, in extreme cases, may not be realized at all. For example, making full use of available customs regimes can reduce production costs and speed delivery times. On the other hand, moving products cross-border without the correct documents and export licenses may result in costly delays and even seizure of the goods.

In Part III of this report, we look at seven common supply chain challenges that global companies face as they move into new markets and operate more effectively and sustainably. We outline leading practices to reduce risks and boost performance in VAT/GST, customs and international trade, excise duties and environmental taxes, export controls and incentives. Although each of these areas present different issues and opportunities, some common themes emerge for adopting an effective management framework for indirect taxes and incentives including:

- ▶ Identify and quantify the indirect taxes and incentives your company currently pays and receives
- ▶ Identify and quantify areas of current and future risk and opportunity, including the costs of related compliance obligations
- ▶ Assign clear responsibilities for managing your organization's indirect tax performance and incentives "assets"
- ▶ Centralize management of indirect taxes and incentives to mirror your business structure and capitalize on knowledge and experience
- ▶ Standardize processes to spread leading practices throughout the organization
- ▶ Outsource and co-source compliance and reporting functions that rely heavily on specialist or local knowledge
- ▶ Involve all the parts of the organization that have a stake in managing and improving your business performance, such as tax, finance, operations, logistics, HR, real estate and so on
- ▶ Measure your management of indirect taxes and incentives by adopting key performance indicators related to your supply chain goals





Part I

The changing supply chain

Supply chains are coming under intense scrutiny as global companies look to thrive and grow in a rapidly changing and highly competitive world. Advances in technology are allowing new goods and services to be designed, manufactured and delivered in new ways. New markets are opening up and old certainties are being challenged. Change is rapid and inevitable.



The shifting patterns of global trade

As new economic powerhouses have emerged in recent years, they have changed the patterns of trade. At the start of the 1990s, global trade was dominated by the developed nations, which accounted for around 80% of merchandise exports. But that share has declined markedly during the past two decades and the recent financial crisis and global recession accelerated the downward trend. By 2010, the advanced economies accounted for a little more than 60% of global merchandise exports and we estimate that the continuing shift toward global outsourcing of production and regional supply chains will further reduce the developed markets' share of global merchandise exports to approximately 55% by 2020.¹

Companies expect to export to more markets during the next few years. In a recent Ernst & Young survey, 30% of corporate executives responded that they anticipate exporting finished products to more than 20 markets in five years.

The continuing economic growth of the East

A decade ago, China wasn't the top trading partner for even one of the Group of 20 (G20) economies. Today, it's the biggest trading partner for six (Australia, Japan, South Korea, India, Russia and South Africa) and it has replaced the US as the top export market for a seventh (Brazil) and risen in importance for the rest.

Asia will continue to be the most dynamic region for trade and the fastest growth of merchandise exports will occur within the region itself. China and India will lead this expansion and the commerce between these two economies is anticipated to grow faster than any other trade route.

Higher prices for primary commodities such as oil and the growth of trade in Asia have helped to boost the combined share of the emerging economies in world exports to 45% in 2010, its highest ever. Already having moved toward production of sophisticated electronics and industrial supplies and away from their former reliance on textiles and other light manufacturing, China, India and other emerging economies will further diversify their manufacturing bases.

Gains in the West

The proliferation of regional supply chains is a trend that reinforces the importance of both China and India within the overall pattern of global trade. However, it would be deceptive to focus merely on growth rates. The sheer magnitude of existing trade in advanced economies means that even a modest growth rate during the coming decade will translate into huge volumes of new trade. While the US share of world exports fell significantly over the past decade, this trend will likely be reversed during the next 10 years because the economic dynamism of Asia is a huge market opportunity for exporters in developed nations.

¹ *Trading Places: the emergence of new patterns of international trade*, Ernst & Young, 2011

“In the past, we’ve been looking at planning very much on a country-by-country basis. But now we’re also knitting that together.

“For example, we know we have agreed to certain processes with the government in country A, we have export credits in country B and an incentive for a factory in country C. Instead of looking at those things individually you can also look at that holistically and say ‘If you add A, B, C together and if we change the flow like this or if we lobby government B for a free trade agreement with country C, that would reduce our cost significantly.’ You see a transformation from local-to-local supply chains to global supply chains.

“It’s no longer the case that a factory only serves the surrounding countries or just the local country. A factory may well be going to supply its goods to the entire world and that changes the dynamic and that also then changes how to look at things.”

– *Head of transfer pricing at a global consumer products company*

Supply chain reorganizations

In response to these changing patterns in global trade, global companies are rapidly transforming their supply chains to go wherever necessary to reduce costs, launch products and enter lucrative new markets. For many companies, supply chain activities such as product engineering, sourcing, manufacturing and logistics are now widely dispersed around the world.

Indirect taxes and supply chain reorganization

Any supply chain restructuring will have an important impact on the company's indirect tax position. For example, what are the new obligations? What is the impact on duty costs? Which company must now account for tax – where is it due and when?

Businesses often launch supply chain restructuring projects without considering the indirect tax implications. But this can mean that risks and costs are increased and valuable opportunities are missed. Indirect tax is relevant for all aspects of the supply chain, including:

- ▶ Development and strategy
- ▶ Research and development (R&D) and design
- ▶ Procurement and sourcing
- ▶ Manufacturing
- ▶ Distribution and logistic
- ▶ Services, both customer-facing and internal

Indirect tax issues for centralized operating models

Supply chain models with a central business entity are particularly challenging from an indirect tax point of view. Centralized operating models often result in an increased number of transactions and companies having to fulfill indirect tax obligations across many geographies. Because these models are intended to obtain operational and financial benefits, indirect tax considerations are typically not at the forefront of the design process.

Even if physical distribution channels are not changed as a result of the centralized model, the indirect tax treatment and application of indirect tax arrangements may be seriously different. It is quite common for centralized operating models to result in a disconnect between physical product flows and the legal and financial ownership of the products. The main indirect tax challenges arise from the central company:

- ▶ Buying in many countries
- ▶ Selling from or to many countries
- ▶ Owning goods in many countries
- ▶ Buying or selling goods on consignment
- ▶ Being involved in chain transactions
- ▶ Moving goods across borders for storage, process and repair
- ▶ Purchasing services from many countries
- ▶ Supplying services in many countries
- ▶ Becoming the owner of all products from raw material through finished product throughout the whole supply chain
- ▶ Keeping title to the finished product until late in the supply chain

During the design of the operating model, attention should be given to the indirect tax implications of the more centralized structure. Unexpected problems may arise if the indirect tax landscape has not been mapped out completely and if all new indirect tax requirements have not been considered.

The change toward a centralized model may result in the central company having to obtain import and export licenses, which may require appointing an indirect tax representative in multiple jurisdictions. Existing incentives could be lost without proper adjustment of the facts associated with them. Customs rules, such as "first sale for export," may no longer be available when companies are removed from the supply chain to allow one central company to own the goods throughout the supply chain. In addition, many jurisdictions will disallow for non-established companies to have the required import, export and regulatory licenses. Often the central company will be required to register for VAT/GST, creating a permanent establishment for direct taxes. The list of potential issues can be endless, effectively creating too many practical problems for the centralized model to be implemented without the necessary indirect tax adaptations.

The indirect tax issues should be addressed up front. Given ample time to implement, most issues can be resolved either by adapting the operating model to better cater for indirect tax or by receiving up-front approval from tax authorities and regulatory bodies.

Insight

Streamlining centers of production

Global Group A manufactures and distributes a wide range of consumer products. In recent years the group has undertaken a number of transformation projects to streamline centers of production and distribution. The first project, carried out in Europe, the Americas and Asia. The global head of transfer pricing discusses how the company's attitude to indirect taxes has evolved from dealing with VAT and customs compliance resulting from these transformations to basing decisions about where to carry out production based on indirect tax considerations. He offered:

"I think there is a difference in the importance of indirect taxes on these projects on a regional basis. If you look at it in Europe, the biggest challenge in general has been making sure that the ERP systems process the indirect tax aspects in such a way that there is less manual activity, that the invoices are all done correctly and that the electronic invoicing systems operate well. In that sense, the harmonization of VAT and customs processes – in the EU at least – has helped significantly.

"In the Americas, indirect taxes were very relevant when we were designing the model, so when we were even defining which transactions would take place, indirect tax and customs were both very relevant. In Europe, we were much more concerned with the compliance process, [but] in the Americas indirect taxes were a prerequisite – although clearly once you get into implementation, the key aspect becomes compliance again.

"We have also gone through a learning process. Whereas in Europe VAT was the big issue, customs was the additional challenge in Asia and the Americas.

"Our supply chain is getting more global every day. So when you make a decision where to build a factory or invest for more capacity, you can then say, 'Well, what's the best place?' and then you need to start thinking about what the customs costs are, who has the best free trade agreements and so on.

"If you look at the transformation in Latin America, indirect tax was actually one of the key focus areas, both on the legal entities setup and for the transaction flows. And another example: recently, we were looking at decisions where to build a factory in Asia and customs and free trade agreements and other indirect taxes and indirect tax incentives are becoming key decision drivers."

Insight

Centralized procurement model

Global Group B manufactures and distributes goods globally. Since 2008, the group has centralized its procurement for a range of goods used in marketing and production, including packaging materials and raw ingredients. The global head of indirect taxes explains how the centralized procurement project has evolved – and how the range of indirect tax issues the group has encountered has expanded to include VAT/GST registration for the procurement company, customs duties on imported goods, excise taxes and environmental taxes. She offered:

“Purchasing is being centralized in a company in Switzerland. The Swiss company takes care of all the agreements with the supplier. It asks the different daughter companies how many X products, will they need in 2012, they feedback that amount, then the procurement company goes out to the suppliers saying we need this amount of X products what kind of deal can you give us? And then it buys all products and sells them on to the production companies.

“We’ve faced a whole range of indirect tax issues in the various phases, as you can imagine.

“First of all, the Swiss procurement entity is now in the supply chain for VAT. This requires it to be registered for VAT in all the countries where it buys and sells locally. It also means that flows now look different. Having the Swiss company involved in the supply chain definitely makes the VAT part more complex because we now have chain transactions where before we only had two parties involved in a transaction.

“The compliance piece is really important because the procurement company is a Swiss entity, in some EU countries it is required that a physical representative take care of all the reporting in the country. We have seen in some countries that, for various reasons, the Swiss company couldn’t get a VAT registration. In these countries we had to apply another model than the standard model, so in that respect indirect taxes have influenced how we do things.

“We have also considered custom duties when goods are supplied across the customs border. Do we need to have the Swiss company registered for importation and exportation, or could we do the flow in a way so it would still be the supplier taking care of the exportation and the local production companies taking care of the importation?

“And now excise and environmental taxes are a big issue. We are really experiencing that now that we are moving more into sourcing finished goods. When it comes to looking into which entity in the chain needs a certain license to be able to deal with excise duties, it’s not the same in every country. Even though the supply chain model looks the same and the transaction is the same, we see that we have to follow very different sets of rules in different countries to accommodate the legal requirements. Just looking at VAT, as long as we were not dealing with excisable product, that was much more straightforward. Now we see that we potentially have to have much more variation in the model we use to be able to also deal with excise obligations.

“As we’ve done the project, our approach has evolved in how we approach it and the role of indirect tax. In the beginning there was a model designed and Indirect Tax had to follow the lead of the other work streams and just make it work. Now, with this latest phase due to the excise duties issues, in Indirect Tax we are pretty much at the forefront so we have been the first to visit the counties and to really go out and get a very detailed understanding to then be an integral part to design the new model. I think we are much more involved now in the detailed design of this procurement model for the future state than we used to be four years ago.”







Part II

Indirect taxes in the supply chain

What do we mean by indirect taxes? In this report, we use the term “indirect tax” to refer to a wide range of taxes levied on the production, sale and international trade in goods and services, including VAT and GST, single-stage sales taxes, environmental taxes and excise and customs duties, which may be levied at the national, state and local level. We also touch on the impact of “green taxes” and look at tax incentives offered by a number of countries and regions to encourage business activity.

Global supply chains increasing indirect tax risk

One reason for the increased volume in international trade in recent years is the globalization of supply chains, which cause goods to cross national boundaries several times during the production process. Each time goods cross a border, they are potentially subject to a host of indirect taxes and indirect tax compliance obligations, including:

- ▶ Export licensing
- ▶ VAT/GST reporting and documentation (to support an export exemption)
- ▶ Customs and excise duty reporting and compliance documentation (duty suspension regimes, etc.)
- ▶ Customs reporting and documentation
- ▶ Customs duties on importation
- ▶ Excise duties on importation
- ▶ VAT/GST and other sales taxes on importation
- ▶ VAT/GST reporting and documentation (to support input tax recovery)
- ▶ Export compliance obligations

The impact of indirect taxes

The effective management of indirect taxes is crucial to operating successfully in today's global market place. As supply chains grow longer and become more international, understanding the impact of VAT/GST, excise duties, customs duties and export controls is not just an issue for the tax function. Indirect taxes must be actively managed throughout the business if they are to work with, not against, your strategic agenda.

Considerations include:

- ▶ **Cost base** – avoiding irrecoverable VAT, excise duties and customs duties
- ▶ **Cash flow** – delayed VAT refunds and prefinanced duty payments
- ▶ **Compliance burden** – managing customs and excise warehouses, applications for incentives, VAT returns and VAT registrations, VAT invoicing, excise returns, customs documentation requirements, managing export compliance obligations

- ▶ **Tax accounting** – real-time VAT reporting, tax provisions
- ▶ **Corporate risk** – reputational risk, penalties, fines and criminal liability for errors and omissions
- ▶ **Growth opportunities** – incentives for setting up new productive activity, intelligent sourcing from or producing in markets where import preferential customs duty rates apply
- ▶ **Efficiency** – customs and excise simplifications, goods held up at customs, business disrupted by tax audits and new activities delayed for incentive grants


Six global indirect tax trends

In our recent report, *Indirect Tax in 2012*, we identified six common global trends for indirect taxes that are likely to be significant in 2012 and beyond:

- 1 Increasing VAT/GST rates
- 2 Broadening of the VAT/GST tax base
- 3 Refinement of consumption tax systems
- 4 Increased focus by tax administrations on compliance and tax avoidance, using advanced technology
- 5 A continuing rise in excise duties
- 6 Decreasing customs duties from increasing free trade



Each time goods cross a border, they are potentially subject to a host of indirect taxes and indirect tax compliance obligations.



Indirect taxes: a growing source of global risk

According to a new survey from Ernst & Young,² tax risk and tax controversy are both rising rapidly. Tax risk is what companies face when they are unsure of having planned their taxes with foresight, accounted for their taxes correctly and complied with all relevant tax laws. And tax controversy is a polite term for the disputes that arise – alas, with greater frequency – between corporate taxpayers and tax authorities.

Ernst & Young asked more than 500 senior tax and finance executives and audit committee members in 18 countries a wide range of questions about their recent experiences and predictions for the future. To gain a fuller picture, several dozen tax administrators and policy-makers were also interviewed.

The consensus is that in both tax enforcement and tax legislation, the landscape is now more challenging than it has ever been.

When asked what specific tax types were most concerning, companies around the world told Ernst & Young that their indirect taxes, including VAT, GST and customs, were a major source of risk and uncertainty.

The complexity of transfer pricing has long been a bone of contention between taxpayer and tax authority and that is still the number-one contributor to tax risk and uncertainty. But indirect taxes were the clear number two and they are the fastest-rising concern, mentioned by far more tax executives than in our last survey in 2009-10 or any of our earlier tax risk surveys.

Why is there so much more tension around indirect taxes now?

Tax executives say the dramatic shift in the global economy has changed tax policy and enforcement, forcing companies and governments into more disputes. Supply chains cross far more national boundaries now and extend into many new markets, including emerging markets, multiplying the customs and VAT considerations.

Also, legislators have been lowering their corporate tax rates to attract business, but they still want to increase spending year over year, so they are all the more likely to raise their indirect taxes. However, even if legislators are convinced that indirect taxes are the best way to raise substantial new revenue, individual taxpayers often disagree. If their protests prevent the rate increases, tax administrators find themselves in a tough situation: they are expected to collect much more without a substantially higher rate.

But tax administrators do have new technological and institutional tools that allow them to collect more, such as formalized cooperation with other tax authorities. Generally speaking, tax authorities have more data and information about taxpayers and their economic activities than at any time in history.

Indirect tax policy as a source of risk

Over just the past few years, between 60% and 70% of European Union member states have increased their VAT rates at least once and the assumption that no state would go over 25% has ended with Hungary's new 27% rate.

These rate increases will continue because when governments urgently demand more revenue, they often turn to indirect taxes, especially the VAT or GST because this broad-based tax produces so much revenue with each rate increase. And even if governments slow their spending growth, they will have to confront their accumulated debt and to do so they will need more revenue.

Since the beginning of 2010, governments have not only been demanding more revenue, they have been demanding it quickly. Italy even announced a one percentage point increase in VAT effective from the following day.

VAT compliance mistakes are more costly when the rate is higher and mistakes are more likely when companies have so little notice. Even governments not in such dire financial straits as Italy are expecting taxpayers to react with uncommon alacrity to tax changes. At the end of 2011, China introduced a complex VAT pilot in Shanghai with only eight weeks' notice.

² Tax risk and controversy survey: a new era of global risk and uncertainty, Ernst & Young, 2011-2012

“In this industry, there is a lot of pressure from people within the supply chain for us (in the tax function) to be embedded and really understand what their strategies are and to build indirect tax planning by way of free trade agreements and other things into that. It’s almost assumed that we will be able to optimize indirect taxes under their structures.”

– Head of indirect taxes at a global automotive company

Indirect tax enforcement as a source of risk

Tax controversy related to indirect taxes is growing at a quick pace as tax legislators constantly adjust the base and raise the rate. This leads to more frequent errors such as:

- ▶ VAT paid to suppliers (input VAT) is not reported and recovered on the VAT return
- ▶ VAT paid to suppliers is reported but not recovered because tax authorities find the supplier’s VAT invoice to be invalid
- ▶ VAT paid to suppliers is recovered when it does not qualify for recovery

Tax policy-makers said they expect indirect taxes to be their leading source of new revenue over the next decade, while tax administrators and taxpayers view indirect taxes as a key source of risk over the next three years.

An increasingly global approach needed to managing indirect taxes

Although companies in our survey reported that indirect taxes are their second leading area of tax risk, they also reported that these taxes were managed by the finance or accounts department more of the time (48%) than they were managed by the tax department (44%). They also reported that a global indirect tax officer was resident in the tax department of only 21% of companies.

Interestingly, this percentage fell to just 12% in the largest companies (those with US\$5b in annual revenues or more), indicating that the larger the company, the less likely it was to have a dedicated indirect tax officer. Looking forward, increasing the number of resources focused on indirect tax in the next two years was foreseen by only 30% of companies. These disconnects merit close attention, particularly as tax administrators and tax policy-makers alike tell us that indirect taxes will be more important to them in the future.

This insight into the current management of indirect taxes shows that amid uncertainty, there is an opportunity for global businesses.

Some companies will seize that opportunity. They will do a good job of planning around the rapidly changing rates and rules and foreseeing where future changes are likely, including what supply chain decisions are wise. Some companies will quickly and efficiently account for new or forthcoming VAT and GST laws, customs and excises. Some companies will comply with all applicable laws, paying all taxes that are due where and when they are due; similarly, they will reclaim all refunds that are due when and where those refunds can be collected. And by following these leading practices, they will avoid indirect tax controversy wherever possible and deal with it quickly and efficiently when it’s unavoidable. These are the companies that will gain a competitive advantage in the years ahead.

Centralized VAT/GST accounting and reporting

Using a shared service center approach wfor global or regional indirect tax compliance and reporting can increase effectiveness while potentially reducing overhead costs. By improving VAT/GST compliance, shared service centers may help to reduce risks and penalty costs. For example, a centralized compliance function may allow groups to maximize the use of standardized automated processes. However, some global companies that have a decentralized VAT/GST compliance model may be concerned that a shared service center compliance team may not have the detailed local knowledge necessary to ensure that all returns are completed accurately and to identify underlying VAT/GST issues. Although this is a genuine concern, increasingly, global companies are addressing it by combining a centralized VAT/GST reporting model with local review of processes, perhaps using a third-party provider.



VAT/GST

VAT/GST is a multi stage tax on consumption that applies to the supply of goods and services at each stage of production, distribution and sale. This broad-based tax is levied on most goods and services, with notable exceptions (such as financial services, insurance, health and education). VAT/GST is charged on the importation of goods and services based on their value, including any customs duties. In contrast, exports of goods and services do not generally attract VAT/GST.

Since it was first introduced, VAT has been an unstoppable tax success story. Some form of VAT/GST now applies in more than 150 countries worldwide, with the US being the only developed economy that does not currently levy a VAT-type tax. And an increasing number of emerging markets are adopting VAT/GST in preference to single-stage sales taxes or a range of local sales taxes. In January 2012, China launched a VAT pilot scheme in Shanghai with a view of eventually replacing its Business Tax (BT) and VAT with a broad-based VAT throughout the whole country. India is also undergoing reform in this area, recently finalizing its “negative list” for excluded supplies and bringing the introduction of a new, centralized GST one step closer.

“Clearly, indirect tax is growing in importance in a current economic environment where governments choose to increase indirect taxes while keeping the corporate rate relatively flat or neutral. So the importance of managing your indirect taxes well is gaining importance as well.”

– *Head of transfer pricing at a global consumer products company*

The VAT/GST compliance burden on business

As a tax on “consumption,” VAT/GST is generally borne by the final consumer, but it is collected and remitted by business entities that supply taxable goods and services. VAT/GST is charged on transactions at each stage of the supply chain and it also generally applies to imports of goods (without the need for a transaction). Businesses are treated as VAT taxpayers who collect and remit the tax. VAT taxpayers charge VAT/GST on their sales (output VAT) and recover VAT paid on their business purchases and overheads (input VAT). Therefore, businesses effectively account for VAT on the value they have added at that stage in the supply chain.

This method of charging and collecting tax from non-taxable persons using VAT-registered businesses makes VAT/GST a highly cost-effective form of taxation from a government perspective, but it places a heavy burden on businesses. They must report and remit VAT/GST payable to the tax authorities on a regular basis (generally monthly for large companies) with 100% accuracy. However, this task is complicated by the fact that each country has its own system with its own rules about how, when and where tax is charged. Documentation and reporting requirements also vary greatly between tax jurisdictions.

The impact of VAT/GST on business cash flow

VAT/GST is a “neutral” tax for most businesses, but the cost of funding VAT/GST is still a factor. Negative cash flow may arise from the sales or purchase functions:

- ▶ **Sales** – The supplier typically has to fund VAT/GST charged to customers that has not been paid by the time the tax return is due (generally monthly) or that is never paid, especially in countries where no relief is given for bad debts.
- ▶ **Purchase** – Waiting for VAT/GST refunds can greatly add to the effective VAT/GST burden for businesses with large VAT/GST credits. Although the VAT/GST is creditable or repayable, many governments do not repay tax quickly. For example, one-off VAT/GST credits may accrue from start-up or merger costs or as a result of increased capital investments. Persistent VAT/GST credits may result from undertaking business activities that are not subject to VAT/GST, such as exports, or to the full rate of VAT/GST, such as books, foodstuffs and pharmaceuticals.

The increase of VAT/GST rates worldwide has a number of important implications. For businesses, higher tax rates increase tax risk, as the amount of VAT/GST that must be managed is greater and the consequences are more severe in the case of non compliance and mistakes. Non-recoverable indirect taxes raise the costs of doing business, making production more expensive and requiring increased efficiency to make up for the increased costs. For governments, as VAT/GST income becomes more important, so does effective enforcement. The fight against fraud and the monitoring of taxpayers becomes more pressing, leading to increased compliance obligations, more aggressive tax audits and harsher penalty regimes.





VAT/GST under management

VAT/GST throughput is all the VAT/GST that a company has to manage. It includes all VAT/GST on purchases and sales plus the full rate of VAT/GST potentially chargeable on lower-rated, zero-rated and exempt activities.

Measuring VAT/GST risk

To understand the importance of managing indirect taxes, you need to measure the full impact on the business by looking at costs, negative cash flow and the amount of VAT/GST throughput or VAT/GST “under management” that represents the level of tax that the company has a statutory obligation to manage effectively. Our experience working with global companies around the world indicates that the VAT/GST under management, regardless of the size of the company, is generally more than 30% of non-US sales income.³

The complexity of the VAT/GST supply chain – looking below the surface

In considering how to manage VAT/GST transaction flows, it is important to recognize that most VAT/GST supply chains are highly complex, involving multiple suppliers and customers and cross-border transactions.

The complexity of the VAT/GST supply chain increases the level of tax risk. For example, risks may arise from the incorrect application of the tax, problems in communication between suppliers and purchasers or a lack of supporting documentation. The whole transaction chain must be mapped and understood if it is to be adequately controlled.

³ VAT and GST: managing the multinational burden, Ernst & Young, 2011



End-to-end VAT/GST: who owns the process?

In considering the management of VAT/GST issues, it is necessary to identify the relevant transactions and the parts of the organization that have ownership of the information and the process. Figure 1 outlines how an examination of fictional Company Z's VAT/GST end-to-end process might identify goals, areas for investigation and improvement and the functions within the company that would be responsible for each part of the process.

Figure 1: Company Z's VAT/GST ed-to-end process

Type of goal	Action	Functional ownership
Strategic	▶ Identify the VATable transactions	Business units/tax
	▶ Determine the correct VAT treatment	Tax
	▶ Assess the risks/opportunities – what is the VAT burden in terms of absolute cost and cash flow? How can it be adjusted to mitigate adverse effects?	Tax
	▶ Finalize the VAT treatment/model – make business case for alterations to current or planned model	Business units/tax
	▶ Communicate to IT/Finance/BUS	Business units/tax/ finance/IT
Operational	▶ Processing and accounting for VAT – record to report	Finance/IT
Compliance	▶ Completing and filing the VAT returns	Finance
	▶ Audits	Finance/tax

“Historically, we haven’t been organized very well for managing indirect taxes. For example, customs cost was not recorded separately, but it was part of a cost line where we aggregated multiple costs like broker fees, freight forwarding costs – and included customs. We had no real idea of what we paid in customs per year, on a global level.

“We are now making sure that we are designing our systems for tax management information. Now that information is actually available, we can monitor it, work with it and potentially identify situations where we need to improve.”

– Tax executive at a Fortune 1000 multinational

Single-stage consumption taxes

VAT/GST is the tax on consumption that applies most widely around the world. However, a number of countries do still apply single-stage consumption taxes at the national, federal and municipal level, such as the sales and use taxes levied in the US and China's Business Tax (BT). These single-stage taxes may apply at any stage of the supply chain, including production, importation, distribution and retail sales. Multiple single-stage taxes may apply in some jurisdictions.

The main business drawback of single-stage taxes is that they generally are not creditable or available for offset, which means that they may add to the cost base. For goods that undergo multiple processes, single-stage taxes may apply at multiple stages, creating a cascading effect (as taxes paid at an earlier stage form part of the taxable base) that leads to very high effective tax rates.

The compliance burden may also be an issue in countries that levy a large number of single-rate taxes. In the US, for example, there are more than 7,500 potential taxing jurisdictions for sales and use tax purposes.



Insight

VAT-led operating conditions for a reengineered logistics network

Global Global Group D purchases materials and manufactures and ships manufactured products all over the world. The group recently reengineered its logistics network in Europe. The global head of indirect taxes describes how the conditions needed to protect VAT zero-rating for intra-EU sales has imposed operating conditions on the group's new logistics network in Europe. He stated:

"In Europe, we have, approximately 40 finished product manufacturing plants in the region in countries stretching from Russia to Morocco. We are responsible for moving product from our suppliers' locations to our Group D locations. Previously, our model was basically plant-centric with each supplier supplying to each plant directly. We had about hundreds of suppliers shipping to multiple locations so you tended to have a lot of suppliers shipping to multiple Group D locations, with lots of carriers executing all these different routes and billing the entities and the related plants for freight. We looked at centralizing our logistics and running it all through one network by going to a series of hubs where the material is accumulated at the supplier locations as efficiently as it can be in full loads and sent to various hubs where it's then redistributed using routes going direct to our destination plants.

"From a VAT perspective it has basically changed the route for materials to get from the supplier to the destinations. And so it has created a whole series of questions about the VAT status of the sale of the materials and what happens to the freight.

"Before implementation, we analyzed how we would run the network and then looked at the VAT legislation in the different countries to understand the rules and whether we would ever have a risk that those types of sales would potentially have a change in the VAT status. We came to the conclusion that yes, in theory, we did have some risk and it was a little bit of a gray area, particularly in certain countries. So we concentrated on those countries and got a ruling from the VAT authorities to protect our zero-rating. Because it's only considered (an intra-EU) dispatch from the originating country if you can show it was actually shipped from the country, it ended up depending on a series of conditions we would have to meet operationally to maintain the zero-rated sales. These requirements have become incorporated in the standard operating procedures for the network.

"One of the new rules is that if carriers want to get paid, they're going to have to provide the documentation up-front we need for VAT purposes. It was also a transformation for our account logistics people and the accounts payable people.

"We also had some customs compliance issues. We had different points of entry and different countries where we had to make the import. So different companies needed to register for VAT and recover VAT at import and so on. We had to work through all of that as well to make the network work. So, we, the VAT and customs people, ended up advising on determining how that was all going to happen."

Customs duties

Customs duties are taxes levied upon importation of certain goods into the customs territory of a country to raise state revenue or protect domestic industries from competitors from abroad. In most cases, customs duties are raised as a percentage of the customs value of the goods, but they may be levied on the basis of other parameters, such as weight or volume.

In addition to standard customs duties, other duties as part of anti-dumping measures and countervailing measures may be levied on the importation of certain goods. These are intended to protect the home market against imported products being dumped on the market or benefiting unlawful or dramatically different subsidies abroad.

In principle, when importing goods into a country, customs declarations need to be filed on a transactional basis for each incoming shipment and these declarations need to be validated by the respective customs authorities. However, there is a trend toward simplifying the declaration process (e.g., consolidated reporting on a monthly basis) even to the point of self-reporting customs duties. And as more customs authorities require the electronic filing of customs declarations, special automated systems have been developed that can deal with multi country customs reporting.

In principle, the level of customs duties depends on the customs value, tariff code and the origin of the goods being imported. In order to identify the various types of goods, specific tariff (HS) codes have been agreed upon internationally to determine import duties (often expressed as a percentage). But the origin of the goods is also a factor. Many countries have agreed bilateral and even multilateral free trade agreements (FTAs) that call for reduced or zero-rate tariff duties for goods originating from a preferred trade partner.

Furthermore, specific valuation methods have been agreed within the World Trade Organization to properly determine the value of the goods being imported. In most cases, the transaction value (price actually paid or payable) can be used as the basis for the customs value. As a result, any price adjustments after the moment of importation (e.g., due to transfer pricing changes) need to be properly reported to the customs authorities.

Customs duties represent a bottom-line cost

Customs duties – unlike VAT/GST – represent a cost for the importer of the goods. A reduction of customs duties immediately improves the cash flow and costs of importing companies. Consequently, various customs procedures have been designed to reduce or avoid the customs duty burden. For instance, goods placed under a bonded warehouse regime can be stored under duty suspension and re-exported to third countries without customs duties being due in the initial country. Economic customs regimes such as processing under customs control and inward and outward processing relief allow companies to reduce the duty burden of imported goods, provided certain conditions are met.

Customs supply chain optimization

An appropriate (re)design of a company's supply chain may reduce the company's customs duty burden, landed costs and lead times. Supply chain optimization projects typically involve trade route rationalization with a maximized use of FTAs and appropriate strategies to reduce customs compliance costs. Combined with the available customs procedures, these strategies can significantly drive down the costs of customs duties and compliance.

For example, goods with preferential origin status could be routed to destinations where preferential origin reliefs can be claimed and goods to be re-expedited could be stored under a customs duty suspension regime to avoid import duties in the country where the storage facility is located (and potentially to safeguard the preferential origin to be claimed in other countries). In this type of arrangement, potential issues to be considered include reverse logistics and online sales, which may represent additional challenges. Further efficiencies also may be obtained by combining a project of this type with the introduction of automated customs systems.

Specific tax-effective supply chain models for procurement and manufacturing also may provide for significant benefits. For example, buying commissions may be excluded from the customs value, thereby reducing the amount of import duties to be paid. In addition, alternative valuation methods (cost plus or resale minus) can be used by toll manufacturers and provide for additional efficiencies in an optimized supply chain.



Reduction of customs duty burden

Various customs planning methods can be combined to reduce the duty spend by price unbundling, where non-taxable elements (e.g., buying commission, sole distribution rights, advertising and promotion costs) can be excluded from the customs value. Similarly, proper branding and intangible property (IP) management may provide room to further reduce the customs value. In addition, the “first sale for export” principle (available in both the EU and the US) allows the customs value of goods to be based on an earlier (lower) sales price under certain conditions. Provided that certain contractual arrangements are made in advance, volume rebates also may be used to decrease the amount of customs duties paid.

Reduce the trapped duty burden and value leakage

Sound analysis and consideration of earlier importations may reveal that significant import duties have already been paid earlier in the supply chain (trapped duty), which may drive up cost of goods sold (COGS) and reduce a company's margins. Optimization of customs procedures and adaptation of contracts with suppliers may provide for significant customs duty savings earlier in the supply chain, thereby reducing purchase prices.

Customs and trade facilitation programs

On an international level, customs authorities have expressed their intention to facilitate global trade through a secure, smooth physical trade process within the World Customs Organization's SAFE Framework. A key concept is the recognition of Authorized Economic Operators (AEOs) who have demonstrated their “trustworthiness” from a customs and trade perspective. AEO status provides for additional customs benefits and trade facilitations. Customs authorities around the world have developed trade facilitation programs such as the Customs Trade Partnership Against Terrorism (C-TPAT) in the US, AEO (in the EU) and the Secure Trade Partnership (STP) in Singapore. As a result of the mutual recognition of trade facilitation programs, goods that are shipped between territories that mutually recognize each other's programs are subject to little or no inspection.

“More and more it is not just VAT that we have to focus on, it's also custom duties. ... Recently, it has also become more excise duties and packaging taxes and other types of environmental fees.

“For businesses like ours, managing indirect tax goes way beyond the traditional view of just looking at VAT and whether it has to be added to a certain transaction or not. I think that is reflected in how we run our Indirect Tax Department and our involvement in the business.

“I am involved when the business decides to structure something differently. Then they say: what would this change mean in respect of your area? do you see any show stoppers? what would be the better way to do it? and so on.”

– Head of indirect tax at a global manufacturing company

Insight

Customs regimes are “standard operating procedure” for “just-in-time” delivery

Global Group D purchases materials and manufactures and ships products all over the world. The head of indirect taxes describes how obtaining – and maintaining – favorable customs regimes are vital for Group D’s just-in-time supply chain delivery model. He said:

“In most countries, we participate in some sort of significant preferential customs program, whether that’s a free-zone, such as IMMEX in Mexico, or similar program, that gives us major benefits.

“In North America, so much of what we do for logistics purposes really hinges on our C-TPAT status. We maintain a centralized logistics network to move supplier materials to our manufacturing plants in North America, including hubs on the Mexican and Canadian borders. We are moving a huge amount of product back and forth, so we had to integrate all our customs requirements into how the network operates in a just-in-time environment to meet our delivery targets.

“We have Tier III status in Mexico which allows us to use customs fast lanes. Now we’ve integrated the expedited time benefits we get from using the fast lanes into our whole network. We have incorporated the expedited border crossing times into our standard logistics network. So maintaining the C-TPAT status has become critical for operational reasons. If we were to lose that status we would have to rework the network and we would have potentially significant short-term cost and operational disruption.

“Everywhere there is a preferential program, we’re in it or getting into it. So right now we’re doing it for AEO. We looked at our profile in each country and said where do we need it most and where do we need it the fastest? Then we prioritize country by country because you have to apply entity by entity. We recognized that to maintain our numerous benefits in many countries we had to join AEO. So, for us the decision was automatic. When a company is in an industry where it’s important to move goods quickly, making sure you qualify for this type of customs and security status becomes a business requirement.”



Excise duties and environmental taxes

The other main class of consumption taxes in the supply chain are excise duties on specific classes of goods. With the broad appearance of modern VAT/GST systems in the 1970s and 1980s, many product-related taxes were abolished. But in recent years they have once again gained importance, mainly because they are seen as a good tool for steering consumption and influencing consumers' behavior while significantly contributing to overall government income.

Excise duties also add to the cost base of production, as they represent a bottom-line cost and are not creditable. In recent years, the rates for alcoholic beverages, cigarettes and hydrocarbon oils have increased in many parts of the world. In addition, as excise duties are normally part of the VAT/GST tax base, any increase in excise duty rates also implies an increase in VAT/GST. Especially in the case of hydrocarbon oils and tobacco products, the revenues raised from taxes are high and the total tax burden on fuel (mainly excise duty plus VAT/GST) often exceeds 100% of pre-tax prices.

A wide range of products are subject to excise duties in individual countries around the world (such as chocolate, coffee and orange juice). However, the three principal product groups that are globally liable to excise duties are alcoholic beverages, hydrocarbon oils and tobacco products. In addition, new taxes are being introduced that seek to influence societal behavior, such as snack taxes on "unhealthy" food (recently introduced in France, Hungary and Denmark) or carbon taxes aimed at reducing climate change and air pollution, as in Australia.

In most cases, excise duties are raised based on the volume or value of the excisable products consumed in a specific country. Excise duties can be raised on the importation or production of excisable goods or when they are made available to consumers.

Reducing the excise duty cost

Excise duty rates are often very high and may represent a significant part of the price of an excisable product. Therefore, it is important to strategically use excise duty reduction, exemption and suspension regimes. As excise duties are typically due at the moment of consumption, companies should make sure that the excise duty is paid only once in the country of actual consumption by using excise suspension regimes (such as a tax warehouses). In addition, various reduced rates and even exemptions may be available under certain circumstances.

Excise compliance burden

Non compliance with excise laws may lead to significant fines (up to 1,000%) and potential criminal prosecution. The excise duty compliance burden and the associated risks may be alleviated by making full use of suspension regimes (to avoid excise duty becoming due) and procedures to delay excise payment as provided for in local legislation. In addition, simplified procedures may be established for excise duty reporting. Finally, companies should pay particular attention to the excise guarantees that need to be deposited, which may represent significant amounts, as some jurisdictions have procedures to reduce these guarantees.

Insight

Local excise duties pose challenges to centralization

The head of indirect tax at a global manufacturing company discusses how it is difficult to centralize management of indirect taxes in a single supply chain model. She offered:

“With excise duties and similar taxes it is hard to get an overview of the applicable fees and regulations and things that may apply in the various countries, because the taxes are dealt with in so many different ways. We see so many different scenarios and set-ups.

“That requires very local knowledge, so that’s quite difficult to centralize and we see that we need to operate with different models in the different countries. I think when you are not an indirect tax person it is the general understanding that the EU is one set of rules, it is more or less same, it cannot be that difficult. But when you work with a supply chain or procurement program you really realize how difficult it can be with these taxes being dealt with differently in the different countries.”



Export controls

Export controls are laws and regulations designed to support national concerns and security policies. They aim to enhance global security by preventing the proliferation of weapons of mass destruction and related terrorist activities. Although these laws and regulations are not new to the international trade community, the need to manage business risk in this area is growing as supply chains become more complicated and far-reaching.

The differing export control laws and regulations that businesses encounter when trading internationally can cause delays in meeting deadlines and contractual commitments. They also can expose businesses to a range of risks that include monetary and criminal penalties, reputational risk, reduced share-price and other punitive measures used by national governments.

Companies that proactively manage their compliance obligations in this area throughout their global supply chain operations may gain competitive advantage.

The US export control regime is often perceived as being the most restrictive and complex. US companies are leaders in high-tech manufacturing and many global businesses are headquartered or operate in the US. Therefore, the US rules are likely to touch the global operations of many companies, either directly or indirectly through their extraterritorial element. Of course, the European export controls regime and its implementation in individual member states have significant positive and negative impacts on operations.

The European export controls and their differing administration through national governments create additional regulations for global companies to understand and comply with. Compliance failures are often seen within businesses that create processes and procedures accounting for only one set of rules (often, in practice, based on the US rules). Companies should analyze their operations and create a compliance framework of expertise, knowledge, processes and procedures to enable compliant trade from all relevant countries.

Partnering export controls and export compliance management with a company's associated customs and trade compliance functions, across multiple jurisdictions, not only provides a logical means of effectively managing compliance obligations, but it also offers greater visibility throughout the end-to-end supply chain. A more efficient and effective compliance function safeguards against the future cost of non compliance while producing faster, more efficient transactions and delivering cost savings.

Insight

Indirect taxes influence the choice of location for low-cost manufacturing

Global Group D purchases materials and manufactures and ships product all over the world. The head of indirect taxes discusses how the decision to locate a manufacturing facility in Europe was influenced by indirect tax decisions. He said:

“I am involved with my income tax colleagues as part of a corporate-wide team looking at sourcing decisions and where to locate new manufacturing facilities. About two-and-a-half years ago, we were looking for a low-cost manufacturing location to support our EU operations and our profile was that we were looking at sourcing materials from both within the EU and potentially from Asia. We were looking for a location that would also deliver us the best answer from an indirect tax perspective. Indirect taxes were a big part of the reason why we located a plant where we did, where we could bring in material into a free-zone type of environment, without any import requirements and export it to the EU relatively easily. And we could source any material we wanted from any location. As long as we transformed it into finished products, shipments were duty free, both into the low-cost country we chose and into the EU.

“So it was an example from an EU perspective where indirect tax considerations were a big driver in where we actually located a plant.”

Incentives

Various incentives exist

Business incentives are measures taken by authorities around the globe to influence desired economic behavior and activity in specific regions and areas of industry. These measures are often targeted at specific activities, including:

- ▶ New investments
- ▶ Job creation, retention, training
- ▶ R&D investments and activity
- ▶ Sustainable development and green operations

Business incentives can be either statutory or discretionary and can include tax and non-tax benefits.

Program offerings differ

A wide range of activities can be impacted by incentives. Programs targeting these activities are available around the globe. Figure 2 indicates the types of incentives that could be applicable to different activities in the supply chain. The types of programs available in each of these incentive categories can be referenced in Figure 3.



Figure 2: Supply chain activities and applicable incentive types

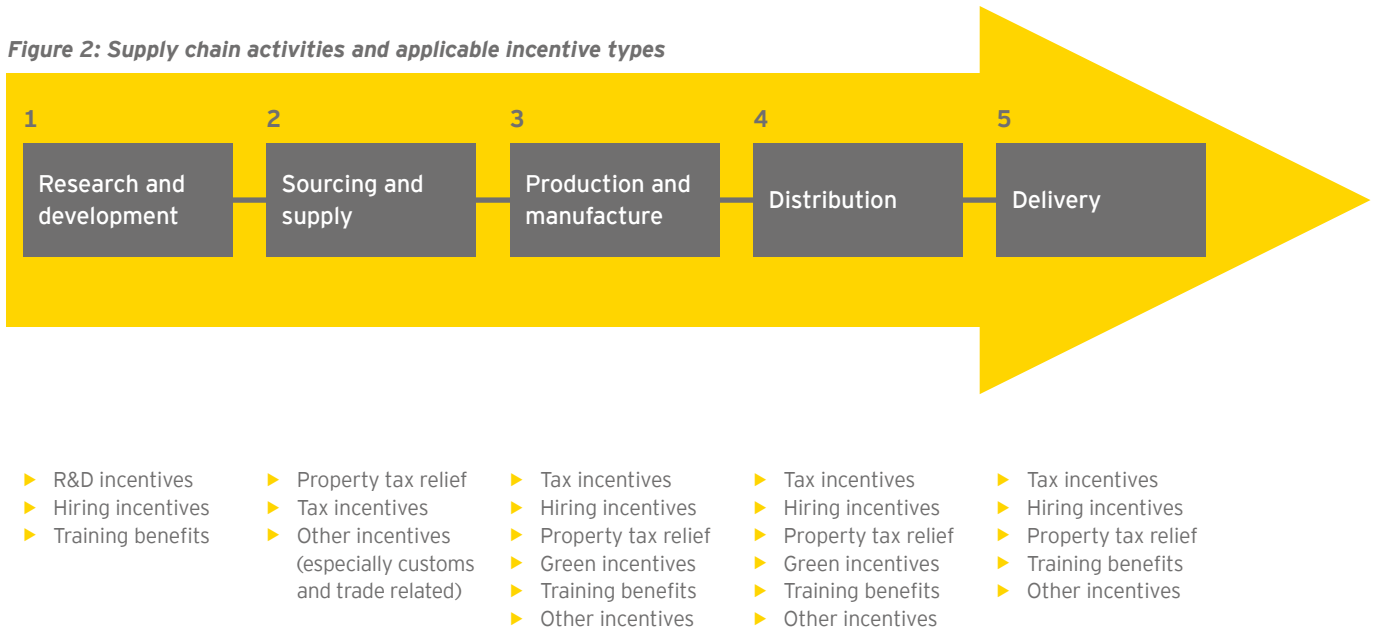


Figure 3: Examples of business incentives

Tax incentives	Hiring incentives	R&D incentives	Property tax relief
<ul style="list-style-type: none"> ▶ Sales/use tax exemptions/refunds ▶ Federal/state EZ credits ▶ Federal/state R&D credits ▶ Capital investment tax credits ▶ Statutory look back reviews ▶ §48C alternative energy ITC ▶ §45D New Markets Tax Credits (NMTC) 	<ul style="list-style-type: none"> ▶ Wage rebates, job creation grants and credits, employment related tax incentives ▶ HIRE Act/ WOTC/WtW ▶ State point-of-hire credits ▶ Hiring and employee screening assistance 	<ul style="list-style-type: none"> ▶ Federal/state R&D credits ▶ FP7 (EU) ▶ R&D cash grants ▶ R&D super-deduction 	<ul style="list-style-type: none"> ▶ Real and personal property tax exemptions ▶ Real and personal property tax abatement ▶ Industrial Revenue Bond (IRB) structuring for favorable property tax treatment ▶ Tax increment financing (TIF)
Green incentives	Training benefits	Other incentives	
<ul style="list-style-type: none"> ▶ Energy efficiency/GHG reduction incentives, credits and grants ▶ Incentives for LEED-certified buildings ▶ §179D deductions ▶ R&D/manufacturing incentives for green products 	<ul style="list-style-type: none"> ▶ Training grants for prospective expenditures ▶ Development/implementation of training programs through state agencies ▶ Training tax credits (retroactive or prospective) 	<ul style="list-style-type: none"> ▶ Infrastructure grants/assistance ▶ Community Development Block Grants (CDBG) ▶ Low-cost financing for capital expenditures ▶ Utility discounts ▶ Waiver of permit fees ▶ Expedited permits ▶ Free or discounted land/buildings ▶ Recovery Zone Facility Bonds 	

Note: black text represents opportunities for cash or cash equivalent benefits (e.g., refundable tax credits, cost reductions) not limited by federal or state tax liability).

How incentives fit into the supply chain framework

Although indirect taxes can increase supply chain-related costs and the risk associated with globalizing these activities, incentives provide an opportunity to offset these costs and decrease supply chain risk. Incentives parallel supply chains in two important ways that can allow companies to leverage these programs to decrease cost and risk and to increase flexibility and responsiveness across global supply chains.

First, incentives are broadly applicable, with programs that target many aspects of business operations. Given that incentives reach across a variety of business activities, they overlap well with supply chain planning and touch many functions within a business. As a result of this overlap, incentives can provide benefit across the layers within a supply chain. By taking advantage of the opportunities on multiple levels, savings will build throughout the process and companies can effectively reduce costs.

Second, in addition to being applicable across a broad range of supply chain activities, incentives are vital to a government's development strategy. Therefore, it is likely that incentives

that apply to a company's operations will be available, regardless of the geographic footprint of its supply chain. This availability is the result of recent trends in incentive development and the prevalence of incentives around the world. Despite the diversity of government agendas and policy, many activities – hiring and training, R&D, customs and trade, sustainability – that represent critical components of supply chains are the common targets of incentive programs around the globe.

The combination of their broad operational applicability and geographic prevalence makes pursuing incentives essential for effective and efficient cost reduction within supply chains. Taking advantage of the savings available as a result of these programs is an opportunity available to almost all players. Incentive diversity and availability mean that a wide variety of companies can use an incentives-based cost reduction strategy. Such a strategy will conserve resources so the responsiveness and flexibility of global supply chains can be improved. The case study to follow bears out the broad applicability of an incentives-based cost reduction scheme by showing its effectiveness for a global clinical research organization.

“You have to look at a range of risks, including reputation. One time a company I was with walked away from significant property tax incentives because they had the potential to harm the local community. We thought it was the right thing to do.”

– *Director of global incentives and grant management at a multinational company*

In a recent internal survey of Ernst & Young's Incentives professionals across the globe's top 25 foreign direct investment recipient countries, almost all countries are trending toward creating incentives for higher value-added activities such as high-tech, innovative applications and higher paying jobs. To this end, we are seeing more complex eligibility requirements that are not always highly transparent, especially in developing countries.

What companies can do to leverage incentives in their supply chains

Every company is different, but these three leading practices apply to any company seeking to effectively apply incentives throughout the supply chain.

1 Select a core incentives team

Because of the diversity of incentive programs discussed above, collaboration among the various stakeholders in a supply chain is imperative. Not only will members of different groups within a company have insight into different potential incentive applications, they will identify any potential hurdles early in the process. For example, the real estate team, after conferring with the tax department, may learn that a cash grant for a new investment may be more valuable than a tax holiday. Or government relations may have a valid concern about a particular incentive. Finally, the R&D team may want to consult with HR and IT to make sure that researchers' time can be tracked on a project basis in order to comply with the reporting requirements necessary for cost reimbursements.

2 Match supply chain spend with available incentives

Once an internal incentives management team has been created, it will be important for the team to apply incentive value across the supply chain and the organization as a whole. Incentives are usually tied to investment or expenditure. Consequently, an important first step in the incentives management process is a review of all supply chain-related spend by activity, jurisdiction and time horizon. This review will allow the different categories of spend to be paired with the incentive programs available for those activities in the jurisdictions where they are occurring. Because each jurisdiction will have its own incentives, it is important for the review to consider jurisdictional as well as activity-based criteria. A leading practice is to consider the full suite of incentives in the site selection process, which in some cases may mean simply adjusting the cost model already in place. For discretionary incentives, this is also the ideal time to negotiate the package.

3 Review of alternative supply chain jurisdictions for potential further cost reductions

After the process of managing incentives is in place, it will be valuable to periodically review both the programs currently being used and the potential for increased savings under newly enacted programs. This review also could result in reduced costs if activities were to be moved to another jurisdiction with more lucrative incentives. Of course, not all locations will be suitable alternatives for some supply chain activities, but those jurisdictions that could provide an effective substitute for a given activity may offer opportunities for additional savings and reduced risk via incentives.

Overall, an effective internal incentives management process will be led by stakeholders from all invested business functions. The core team will regularly review all the components of supply chain spend by activity, jurisdiction and time horizon in order to match incentives to eligible activities and it will monitor new incentive programs in countries representing potential alternative destinations for supply chain activity in order to stay abreast of the most valuable savings opportunities.

Insight

Managing the incentives asset

Global Company E is a large life sciences company headquartered in the US. The director of global incentives and grant management talks about why her role was created, the types of incentives on offer and the framework that the company has evolved to manage its “incentives asset” effectively. She offered:

“This role was created about two-and-a-half years ago. Company E is in a growth industry and expanding globally and had received economic development packages all over the world, but we were handling them in a decentralized way. We realized that we had a big asset that needed to be managed and protected and that we could also seek out additional incentives and opportunities to support our expansion. That’s really what my role is. Also, because I have an expertise in tax, I help manage the tax credits side of things as well.

“Typically, governments have a range of economic development tools that are available and although they vary throughout the world, they are also very similar. Generally, a government will calculate the increased tax base a new project is going to bring to the jurisdiction – property tax, sales tax, VAT, corporate and personal income tax, business tax or whatever taxes there are in the jurisdiction – and they try to figure how they can share part of those taxes back with you to attract and support the project. Sometimes they do it through tax credits like a job creation, investment tax credit or an R&D credit tax. Sometimes they give it back to you in a tax holiday, giving a discounted income tax rate for many years. Another way is through grants based on your investment, job creation and maybe on the amount of training you are going to do. Grants could be free land or a break on the rent. They could put in infrastructure for you. They can put energy in or broadband if you need more capacity or bandwidth. They can buy the building and lease it back to you. They can facilitate special arrangements with the local universities in order to gain access to academic researchers that you need or get special training for your people and workforce development. Things like that.

“Depending on what part of the world you are in, there is a philosophy of whether it’s better to give companies tax credits or whether it’s better to give them cash grants, but most places give a combination. What is available is based on an economic impact decision that usually has to do with job creation and how much tax revenue you are going to generate in the locale.

“Depending on the size of your company, you have to look at your incentives portfolio: how many incentives do you have? How they are managed? It is an asset. What is the asset worth right now and what do you think the future asset will be worth? If that is a big number, then somebody should be paying attention to it and that means probably that there should be resources dedicated to it – maybe even a department or a small group of people. At a minimum, you need someone in the company who is responsible, who is accountable.

“When you get started it’s important to surround yourself with external practitioners with a lot of experience to help you develop the infrastructure because a lot of times you don’t even really know what you have. You have an idea what you have, but it’s dispersed throughout the company and perhaps the world, so you need to do an inventory. And then, you need to see how it’s currently been managed and to see what the risks are and make decisions about whether or not that is an appropriate way to continue or whether the activity should be more centralized.

"I find having a centralized function is important because there is so much commonality between how these things are reported and how they are negotiated. If you can have the same people involved in multiple projects, you really leverage your knowledge on one project after another. If you have one set of business people who are on project A. They negotiate this once-in-a-lifetime deal and then you have project B, with totally different people, you don't get any leverage. There is no transfer of knowledge, no lessons learned.

"We have a matrix organization. I have globally responsibility so I need to leverage my regional finance team (that don't report to me) to support my projects in the regions. I have finance and real estate people that support the effort. HR even lends a hand to support the training grants and the data needed for compliance. These people don't report to me, but the company has made incentives a priority so if I need help, I get it. It's a very supportive group and they understand the importance of these incentives to the company's bottom line.

"Since I'm a department of one, I do very little of the compliance myself. I have trusted business partners inside the company and I have trusted business partners outside the company and those external business partners help me with the compliance. They also help me scope out, develop, negotiate and secure new opportunities.

"Before seeking new incentives, we always do a cost/benefit analysis. Sometimes we forgo incentives because they are too much work. We set a threshold, so we don't spend time on incentives unless there is a strong return on investment. And then we look at the compliance burden and we look at the risk. I mean when I started in this career, my philosophy was 'I am going out to get everything' but now I think 'Let's turn over all the big rocks first and then if there are any little rocks, we will go back and get them, if it makes sense to.'

"The business people will say the incentives are not going to drive this decision. But, incentives definitely can influence the business decision. For example, we have a site we picked recently because it was in an economic development zone and we had other sites that we were looking at that were equal otherwise, so that difference tipped the balance. That is especially true in regions that have special economic zones. In China for example, they have designated business parks with lots of incentives attached. But if you are literally across the street, the same incentives are unavailable. I think helping the real estate people and the business decision-makers know that is not intrusive. The information helps the business people make the best decision for the company overall. The incentives add to the project's bottom line.

"Many things that we do can be done anywhere in the world. One of the things that I have done is prepared an incentives matrix for all the countries where we do business where we have 100 or more employees. When I get a call from one of our businesses that needs to hire say 100 people in Asia, I can pull my matrix out and I can say this is where we should start looking.

"So the business decides to expand, but it's where and when the expansion takes place, that can be influenced."



Interview

Ernst & Young interviewed Paul Wookey of Locate in Kent, the investment promotion agency for the county of Kent in England. We asked Paul about the role of the incentives in attracting investment, incentive trends in Europe and how companies should evaluate incentive offerings.

Paul Wookey

Our job is to attract business to the county of Kent. Ultimately, our objective and our key performance indicator is the creation of jobs. We provide a free and confidential service as most investment promotion agencies across the world would do. We are a not-for-profit organization and we have a mix of funding from both public and private sector sources to fund our operations.

We don't sell Kent on the back of whatever incentives are available. What we always say is that obtaining a grant should make a good decision better rather than making a bad decision better. Really it is the thing that would possibly just tip the balance in favour of the location.

But in our experience, when overseas investors are looking at the UK or Europe, one of the first questions they will ask is 'What incentives are available in that particular location?' If you haven't got any incentives to offer you usually won't even get to the short list for that company's decision-making criteria. They will very quickly move to consider areas where there will be some financial support.

One of the differentiators that we currently have in the UK is the ability to offer some tax benefits, particularly things like research and development tax credit or the proposals for the patent box regime that comes in next year. And obviously the reduction in corporation tax was aimed at making the UK a much more attractive environment for investment. These are very important and they come into the mix when we are talking to

companies because if they are looking at a Northern European location they will be doing a comparison of tax rates and things like the social cost, national insurance and the personal income tax regime. And then there are specific measures that we offer locally to supplement the national incentives that are on offer.

Ernst & Young

Are there major differences between Kent and other counties in England and Wales?

Paul Wookey

Yes. Kent made a bid for the Regional Growth Funds last year. The area of East Kent, which is the areas of Thanet, Dover, Canterbury and Folkestone, has been awarded £40m worth of Regional Growth Funds and that was in direct response to the announcement that a multinational was going to exit its Sandwich facility, which left a large hole in the number of jobs in the area.

That site, which is now being transferred by the government into another private ownership, has been designated an enterprise zone. And with £40m that has been awarded to the surrounding area there is a package of soft loans and/or grants that will be made available to companies seeking to invest in that area. Anyone may apply for up to £2.5m of the soft loans or direct grants to support job creation. Then if you match or if you add on top of that the enterprise benefit, which will equate to about £55,000 a year and £275,000 in total over five years, plus the corporate tax regime you begin to create a cocktail of financial incentives

that overlay the natural attractiveness of that area, making it more attractive and more competitive than many of the other locations that a company might be looking at.

But I have to say that my own belief is that most companies are not primarily going to be driven in where they make their investments purely on the basis of the financial incentives. I think there are many other attributes of an area that will determine whether it's the best location for an individual business.

Ernst & Young

Is that one of the ways in which Kent competes with other locations around the world?

Paul Wookey

Yes, I think this makes us more attractive and more competitive where we are dealing with some of the bigger mobile projects and where, say, a US company is looking for a European operation but can't decide whether to go into Northern Europe or into the UK.

I don't think we have ever worked on a project where it has been Kent, somewhere in the US or somewhere, in say, the Far East that are competing, it doesn't work like that for us. What we usually are doing is competing with Northern European locations where, generally speaking, the incentives are quite competitive. So unless we are able to compete at that level we don't get to see some of those projects.

Ernst & Young

What trends are you seeing for fiscal incentives in the UK and in the EU?

Paul Wookey

The theory goes that the whole of Europe is determined by the EU state aid rules so that there is a level playing field across European countries. But it's quite interesting seeing what is happening with the Eurozone debate and discussions around trying to regularize and maybe control interest rates. Our experience is that every country is going to try to be as competitive as it can be to win investments and ultimately to secure economic growth.

Many will find ways to offer some additional incentives. It's a bit like what we are doing with the Regional Growth Fund. Through the fact that we have been able to secure this £40m we can offer zero interest rate loans plus grants to companies looking to invest in this area. We are doing that within the state aid rules because the areas where this money is going to be used meet the state aid requirements.

Some of the newer EU countries tend to have a lower cost base with lower salary cost and generally lower operating costs. So, if the investment project is really being driven by low-cost I don't think the UK very often gets on to the short list, let alone Kent, because the UK is likely to be deemed to be an expensive location. But cost is not the only factor. What we are seeing is that we are winning projects largely because we've got the skill base.

I would stress that companies should not be making their decisions purely on the incentives that are offered. There have to be other good reasons to locate a project and an investment in an area. And they have to be looked at in a much broader sense. Companies really need to take good sound advice. And it's only at the end of the analysis around a whole range of factors that you will see whether the incentives really make a difference.





Part III

Meeting indirect tax challenges in the supply chain

Our report shows that companies are responding to this challenge in three key ways. Firstly, they are adapting their supply chains to support rapid expansion and capitalize on the growing number of middle-class buyers in emerging markets, while managing risk. Secondly, they are further developing their existing supply chains to drive cost efficiencies and boost margins in their mature market operations. And thirdly, they are developing policies around sustainability and adapting how they source materials and manufacture and distribute finished products to reduce their impact on the environment and the communities where they operate.

Within these three main areas, we have identified seven interconnected items on the Supply chain framework (Figure 4). These interconnected items are key areas of focus for supply chain transformation to promote growth, improve margins and address environmental issues. Indirect taxes can be a barrier to success in these sectors, for example, by increasing the landed cost of goods, or they can enhance opportunities, through incentives and “soft” loans. In this part of the report, we look at how opportunities and risks may arise in the supply chain framework for the following: VAT/GST; customs and international trade; excise and environmental taxes; export controls and grants and incentives. We also touch on some of the leading practices used by global companies to effectively manage within their complex supply chains.

Figure 4: Supply chain framework

With slow revenue growth in mature markets, the supply chain must create sustainable cost savings to support margins and to help pay for growth elsewhere.



The supply chain must enhance its core competency to become a strategic business enablement vehicle to drive top-line growth.



Managing indirect taxes to improve margins



During the economic downturn, global companies have struggled to maintain and increase margins, especially in developed markets where they face a combination of increasing costs and pricing pressures. In response, businesses in developed markets are looking critically at their costs, stripping out unnecessary taxes and duties, reducing borrowing requirements and maximizing grants and incentives. These can all be effective strategies in reducing the cost of producing, selling and distributing goods. For example, economic customs regimes may avoid duty for contract manufacturing, grants and soft loans may be available for creating new employment opportunities and VAT/GST charged to domestic customers may be avoided by selling goods cross-border.

Some multinationals are reconfiguring their supply chains to become more “customer-centric,” to reduce overheads, operate more efficiently and benefit from economies of scale. They are changing

how they purchase goods and services, carry out key functions and deliver their goods by centralizing and rationalizing logistics, procurement, production and distribution. These changes all have a profound impact on indirect taxes, particularly on compliance obligations. If these taxes are not managed effectively they can increase costs, have a negative impact on cash flow and delay product deliveries. For example, a change in the company that buys and sells products has a knock-on effect for VAT/GST, excise duties, export licenses and customs regimes. Failure to recognize and manage the new obligations can result in major business disruption and large financial penalties.

Risks can be avoided by involving indirect taxes as part of any supply chain transformation project from the start. In fact, looking critically at indirect taxes and grants and incentives may highlight new opportunities to strip out costs, reduce financing and improve operational efficiencies.

VAT/GST

The main objectives for VAT/GST in this area of the supply chain framework are:

- ▶ Reducing the burden of VAT/GST, both in terms of absolute costs and in terms of negative cash flow
- ▶ Maximizing positive VAT/GST cash flow on sales and purchases
- ▶ Reducing the costs of compliance and the risk of incurring penalties

The main issues for VAT/GST include:

- ▶ Absolute VAT/GST costs e.g., input VAT/GST that is not recoverable or that is missed due to poor VAT/GST management, foreign VAT/GST that is not available for recovery and double taxation arising from mismatched systems
- ▶ Negative cash flow e.g., VAT/GST accounted for on sales but not yet paid (or never paid) by purchasers, VAT/GST paid on imports and purchases that has not been reimbursed or offset, foreign VAT/GST that is not picked up for recovery
- ▶ Financial penalties from failing to comply with VAT/GST obligations e.g., penalties incurred for incorrect invoicing or for late VAT/GST registration in a foreign jurisdiction
- ▶ Administrative costs associated with multinational VAT/GST compliance obligations

Leading practices for reducing the cost burden of VAT/GST include:

- ▶ Adopting an effective VAT/GST management framework to identify, quantify and manage transactions and cross-border movements of goods, throughout the end-to-end supply chain
- ▶ Mapping out VAT/GST transaction flows against costs to identify opportunities to strip out VAT/GST costs and improve cash flow
- ▶ Standardizing and automating end-to-end processes (especially AR and AP processes)
- ▶ Centralizing VAT/GST compliance in global or regional shared services centers
- ▶ Routing cross-border movements of goods to make best use of import VAT/GST deferments, free trade zones, reverse charge accounting, etc. to improve cash flow and avoid irrecoverable VAT/GST

Customs and international trade

The main objectives for customs duties in this area of the supply chain framework are:

- ▶ Reducing customs duty spend to reduce the landed cost of products
- ▶ Smoothing customs clearance processes

The main issues for customs duties include:

- ▶ Absolute costs from “trapped duty” paid at an earlier stage of the supply chain that increase the landed cost of products
- ▶ Penalties, delays and seizure of goods arising from non compliance with customs compliance procedures, such as origin management, economic customs procedures and accounting and anti-bribery laws
- ▶ Absolute costs related to product delays (e.g., use of air freight to meet just-in-time delivery conditions)
- ▶ Costs and risks related to using non compliant customs agents for importations
- ▶ Duties and penalties imposed as a result of countries applying different legal interpretations to basic customs principles (such as the country of origin, the commodity code and the product value of the goods)

Leading practices for reducing the cost burden of customs duties include:

- ▶ Adopting an effective customs duty management framework to identify, quantify and manage transactions and cross-border movements of goods, throughout the end-to-end supply chain
- ▶ In-sourcing customs activities to improve processes and data management
- ▶ Applying economic customs procedures (such as OPR, IPR) and customs planning tools (such as classification and origin) where available
- ▶ Routing cross-border movements of goods to make best use of free trade agreements and free trade zones
- ▶ Optimizing sourcing of goods to maximize the use of customs procedures (e.g., origin)
- ▶ Using accreditation (such as AEO) to transit goods more quickly through international borders
- ▶ Linking the use of special customs regimes in the end-to-end supply chain

Excise and environmental duties

The main objectives for excise duties in this area of the supply chain framework are:

- ▶ Reducing excise duty spend to reduce the landed cost of products
- ▶ Ensuring excise duties are paid solely in the country of consumption

The main issues for excise duties include:

- ▶ Absolute duty costs arising from paying irrecoverable duties in more than one country
- ▶ Penalties, delays and seizure of goods arising from non compliance with legal requirements
- ▶ Administrative costs associated with local excise duty compliance obligations in multiple countries

Leading practices for reducing the cost burden of excise duties include:

- ▶ Adopting an effective management framework to identify, quantify and manage excise duties and licenses throughout the end-to-end supply chain
- ▶ Optimizing the use of excise duty planning including suspension and exemption regimes
- ▶ Aligning excise duty planning with customs and VAT/GST suspension regimes, free trade zones and warehousing to maximize benefits and reduce the overall duty burden

Export controls

The main objectives for export controls in this area of the supply chain framework are:

- ▶ Reducing the cost of export compliance
- ▶ Reducing export lead times

The main issues for export controls are:

- ▶ Administrative costs arising from complying with complex regulations in multiple jurisdictions
- ▶ Penalties, delays and seizure of goods arising from non compliance with export license procedures

Leading practices for reducing the cost burden of export controls include:

- ▶ Adopting an effective management framework to identify, quantify and manage export licenses throughout the end-to-end supply chain
- ▶ Embedding export compliance obligations into business processes
- ▶ Centralizing compliance in global or regional shared services centers
- ▶ Using customs accreditation (such as AEO) to transit goods more quickly through international borders

Incentives

The main objectives for grants and incentives in this area of the supply chain framework are:

- ▶ Reducing the cost of raw materials and overhead costs (including the costs of employees, real estate, energy and finance)
- ▶ Increasing capital investment

The main issues for incentives are:

- ▶ Administrative costs arising from complying with complex qualifying conditions in multiple jurisdictions
- ▶ Absolute costs of clawed back incentives that were granted previously
- ▶ Missed incentive opportunities because of poor compliance or tracking of programs or because the available incentives are not appropriate (e.g., a tax holiday for a company with no taxable profits)

Leading practices for reducing the cost burden of incentives include:

- ▶ Adopting an effective management framework to identify, quantify and manage the incentives "assets"
- ▶ Centralizing management of grants and incentives to improve controls, improve decision-making and maximize in-house experience
- ▶ Evaluating the benefits available compared with the compliance conditions and costs
- ▶ Identifying potential investment destinations and negotiating investment packages that are tailored to the company's needs to maximize benefits and cost reductions
- ▶ Combining grants or credits for new investment, employment and R&D, etc. to minimize input costs throughout the supply chain

Managing indirect taxes to support sustainability



Governments around the world are struggling to find the right balance between promoting economic growth and protecting the environment. Issues of sustainability have also climbed the corporate agenda in recent years and will continue to have a profound effect on supply chains in the future.

Many countries have turned to indirect taxes and incentives to support a “green” agenda. For example, the excise duties related to mineral oils have increased in many countries; several jurisdictions have also adopted one-off levies, such as carbon taxes and packaging duties, aimed at discouraging waste, pollution and the use of fossil fuels. These environmental taxes can increase the cost of overheads, and the production and distribution cost of raw materials. And failure to comply with multiple local requirements can lead to business disruption, fines and delays. But companies that adopt greener policies may benefit from a range grants and incentives aimed at attracting the use of cleaner industries and technologies and non polluting activities (such as R&D and high-tech).

Environmental duties

The main objectives for environmental duties in this area of the supply chain framework are:

- ▶ Ensuring full compliance with local taxes
- ▶ Reducing environmental duty spend to reduce the landed cost of products
- ▶ Avoiding product delivery delays

The main issues for environmental duties include:

- ▶ Absolute duty costs arising from paying irrecoverable duties
- ▶ Penalties, delays and seizure of goods arising from non compliance with legal requirements
- ▶ Administrative costs associated with local environmental duty compliance obligations in multiple countries

Leading practices for reducing the cost burden of environmental duties include:

- ▶ Adopting an effective management framework to identify, quantify and manage environmental duties and licenses throughout the end-to-end supply chain
- ▶ Centralizing management of environmental duties (e.g., in a global or regional shared service center) to improve quality of compliance and reduce costs
- ▶ Embedding environmental concerns into the supply chain and modifying products or processes to reduce or avoid one-off duties (e.g., packaging and carbon taxes)

Incentives

The main objectives for grants and incentives in this area of the supply chain framework are:

- ▶ Covering or reducing the cost of setting up businesses that will carry on sustainable activities
- ▶ Covering or reducing the cost of adapting current infrastructure and business practices to be more sustainable

The main issues for incentives are:

- ▶ Compliance costs associated with complex qualifying conditions in multiple jurisdictions
- ▶ Absolute costs of clawed back incentives that were granted but for which the conditions have not been met
- ▶ Missed incentive opportunities because of poor compliance or tracking of programs or because the available incentives are not appropriate (e.g., a tax holiday for a company with no taxable profits)

Leading practices for reducing the cost burden of incentives include:

- ▶ Adopting an effective management framework to identify, quantify and manage the incentives "asset"
- ▶ Centralizing management of grants and incentives to improve controls, improve decision-making and maximize in-house experience
- ▶ Evaluating the benefits available compared with the compliance conditions and costs
- ▶ Identifying potential investment destinations and negotiating investment packages that are tailored to the company's needs to maximize benefits and cost reductions
- ▶ Combining grants or credits for sustainability programs for multiple concerns, such as renewable energy, waste management and production efficiencies

"I am seeing a trend right now in China and in other places too where they are starting to talk about attracting 'no carbon footprint' businesses. They want to attract businesses like outsourcing and life sciences that aren't going to pollute."

– *Director of global incentives and grant management at a multinational company*

Managing indirect taxes to support growth in new markets



To deal with difficult economic conditions in developed economies, in recent years, global companies have developed new products and expanded into new markets. Developing an effective supply chain operating model is critical to achieving and maintaining high levels of growth within emerging markets. A wide range of grants and incentives – from tax holidays to soft loans and R&D support – are offered to attract global companies to new locations.

But operating in unfamiliar territories can challenge corporate functions to the limit and expose an organization to a wide range of risks. The mix of indirect taxes in emerging economies, for example, may be unfamiliar to companies headquartered in Europe and the US. For example, excise taxes may apply to a wider range of products and customs duty rates may be higher, or the country may not yet have a well-developed network of free trade agreements.

Operating in new markets can also increase the difficulty of managing indirect taxes and the complexity of obligations, thus increasing the risk of incurring penalties for non compliance. Failing to comply fully with indirect tax requirements can have severe consequences in countries which impose high penalties for errors and omissions (including severe financial penalties, business closure and criminal sanctions for business officials). For example, as companies enter new markets they must ensure that they are aware of and ready to comply with all their obligations before they commence operations. Companies that are comfortable with European-style VATs may struggle with the single-stage consumption taxes, such as business tax in China, or the multiple local taxes charged in India and Brazil.

Changes in indirect tax systems can also add to the complexity. In many emerging economies, new and reformed taxes may be introduced and taxpayers' systems and processes must adapt, often at short notice, to keep the business operating. For example, the recent VAT pilot in Shanghai was introduced with just eight weeks notice.

Risks can be avoided and the benefits of entering new markets preserved by involving indirect taxes as part of any business expansion project from the outset. In fact, looking critically at indirect taxes and incentives may help to decide where and how new activities should be undertaken.

VAT/GST

- ▶ Reducing the burden of VAT/GST, both in terms of absolute costs and in terms of negative cash flow
- ▶ Reducing the costs of compliance in multiple jurisdictions
- ▶ Reducing the risk of incurring penalties in unfamiliar jurisdictions and new tax systems

The main issues for VAT/GST include:

- ▶ Administrative costs associated with adapting to VAT/GST compliance obligations arising from doing business in new markets
- ▶ Absolute VAT/GST costs e.g., input VAT/GST that is not recoverable or that is missed due to poor VAT/GST management, foreign VAT/GST that is not available for recovery and double taxation arising from mismatched systems
- ▶ Negative cash flow e.g., VAT/GST accounted for on sales but not yet paid (or never paid) by purchasers, VAT/GST paid on imports and purchases that has not been reimbursed or offset, foreign VAT/GST that is not picked up for recovery
- ▶ Financial penalties from failing to comply with VAT/GST obligation e.g., penalties incurred for incorrect invoicing or for late VAT/GST registration in a foreign jurisdiction
- ▶ The effect of a new VAT/GST being introduced or of consumption tax reform on business processes and accounting and reporting requirements

Leading practices for reducing the cost burden of VAT/GST include:

- ▶ Adopting an effective VAT/GST management framework to identify, quantify and manage transactions and cross-border movements of goods, throughout the end-to-end supply chain
- ▶ Mapping out VAT/GST transaction flows against costs to identify opportunities to strip out VAT/GST costs and improve cash flow
- ▶ Standardizing and automating end-to-end processes (especially AR and AP processes)
- ▶ Centralizing VAT/GST compliance in global or regional shared services centers
- ▶ Proactively planning for new compliance requirements and changes to tax systems
- ▶ Routing cross-border movements of goods to make best use of import VAT/GST deferments, free trade zones, reverse charge accounting, etc. to improve cash flow and avoid irrecoverable VAT/GST
- ▶ Adopting a centralized or regional supply chain model and implementing a VAT/GST-free procurement, manufacturing and sales model to meet business needs and just-in-time delivery targets

Customs and international trade

The main objectives for customs duties in this area of the supply chain framework are:

- ▶ Reducing penalties and delays related to customs compliance
- ▶ Smoothing customs clearance processes
- ▶ Identifying increased customs spend
- ▶ Reducing customs duty costs for landed goods and within the manufacturing chain

The main issues for customs duties include:

- ▶ New customs duties, obligations and opportunities arising from doing business in new markets or trading in new products
- ▶ Absolute costs of “trapped duty” paid at an earlier stage of the supply chain increasing the landed cost of products
- ▶ Penalties, delays and seizure of goods arising from non compliance with customs compliance procedures, such as origin management, economic customs procedures and accounting and anti-bribery laws
- ▶ Absolute costs related to product delays (e.g., use of air freight to meet just-in-time delivery conditions)
- ▶ Costs and risks related to using non compliant customs agents for importations
- ▶ Duties and penalties imposed as a result of countries applying different legal interpretations to basic customs principles such as the country of origin, the commodity code and the product value of the goods

Leading practices for reducing the cost burden of customs duties include:

- ▶ Adopting an effective customs duty management framework to identify, quantify and manage transactions and cross-border movements of goods, throughout the end-to-end supply chain
- ▶ In-sourcing customs activities to improve processes and data management
- ▶ Applying economic customs procedures (such as OPR, IPR) and customs planning tools (such as classification and origin) where available
- ▶ Routing cross-border movements of goods to make best use of free trade agreements and free trade zones
- ▶ Optimizing sourcing of goods to maximize the use of customs procedures (e.g., origin)
- ▶ Using accreditation and facilitation programs (such as AEO, CT-PAT) to transit goods more quickly through international borders
- ▶ Linking the use of special customs regimes in the end-to-end supply chain
- ▶ Negotiating with tax authorities to make full use of cost reduction programs

Excise and environmental duties

The main objectives for excise duties in this area of the supply chain framework are:

- ▶ Reducing excise duty spend to reduce the landed cost of products
- ▶ Ensuring excise duties are paid solely in the country of consumption
- ▶ Smoothing logistics for excisable products processes

The main issues for excise duties include:

- ▶ New excise duties and obligations arising from introducing new goods onto the market or existing goods into new markets
- ▶ Absolute costs arising from “excise leakage” (paying irrecoverable duties in more than one country)
- ▶ Penalties, delays and seizure of goods arising from non compliance with legal requirements
- ▶ Administrative costs associated with local excise duty compliance obligations in multiple countries

Leading practices for reducing the cost burden of excise duties include:

- ▶ Discussing new activities and new product with local tax authorities to explore available excise duty programs and applicable conditions
- ▶ Adopting an effective management framework to identify, quantify and manage excise duties and licenses throughout the end-to-end supply chain
- ▶ Defining excise duty management obligations and agreeing them in specific service agreements
- ▶ Identifying local excise duty planning including suspension and exemption regimes
- ▶ Using centralized excise licenses and direct transportation to optimize payment facilities and deposit guarantees
- ▶ Aligning excise duty planning with customs and VAT/GST suspension regimes, free trade zones and warehousing to maximize benefits and reduce the overall duty burden

Export controls

The main objectives for export controls in this area of the supply chain framework are:

- ▶ Reducing the cost of export compliance
- ▶ Reducing export lead times

The main issues for export controls are:

- ▶ Administrative costs arising from complying with complex regulations in multiple jurisdictions
- ▶ Penalties, delays and seizure of goods arising from non compliance with export license procedures
- ▶ Operating in emerging markets may increase compliance risk

Leading practices for reducing the cost burden of export controls include:

- ▶ Adopting an effective management framework to identify, quantify and manage export licenses throughout the end-to-end supply chain
- ▶ Embedding export compliance obligations into business processes and across multiple corporate functions
- ▶ Centralizing compliance in global or regional shared services centers
- ▶ Using customs accreditation (such as AEO) to transit goods more quickly through international borders

Incentives

The main objectives for grants and incentives in this area of the supply chain framework are:

- ▶ Adding value to business decisions related to new markets and new activities
- ▶ Reducing costs of setting up and doing business in new locations or undertaking new activities
- ▶ Supporting capital investment

The main issues for incentives are:

- ▶ Administrative costs arising from complying with complex qualifying conditions in multiple jurisdictions
- ▶ Missed incentive opportunities because of poor compliance or tracking of programs or because the available incentives are not appropriate (e.g., a tax holiday for a company with no taxable profits)

Leading practices for reducing the cost burden of incentives include:

- ▶ Adopting an effective management framework to identify, quantify and manage the incentives “asset”
- ▶ Proactive consideration of available incentives during the investment planning process to build savings into the business decision-making process
- ▶ Centralizing management of grants and incentives to improve controls, improve decision-making and maximize in-house experience
- ▶ Evaluating the benefits available compared with the compliance conditions and costs
- ▶ Identifying potential investment destinations and negotiating investment packages that are tailored to the company’s needs to maximize benefits and cost reductions
- ▶ Combining grants or credits for new investment, employment, R&D to minimize input costs throughout the supply chain
- ▶ Incentives related to product or service development may increase employees’ skill levels and extend the benefits of R&D within the organization

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EYG no. DL0570

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ED 0113