

VAT and business restructuring or relocation projects

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If not addressed properly VAT can become a huge cost for companies undergoing business restructuring or relocation projects.

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approached proactively.

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I. Introduction

In the past several years we have observed a clear shift of balance from direct to indirect taxation. Consequently, VAT is becoming more and more of a priority for businesses. Thus it is remarkable that, when restructuring or relocating their business, companies frequently do *not* consider the VAT ramifications of the change despite the fact that VAT can become a huge cost for companies if the issue is not

II. Value Chain Transformation

The reasons for business restructuring differ from industry to industry and even from one business to another within a specific industry. In times of economic malaise, companies need to rethink their strategy in order to reduce costs whilst other businesses feel the impact of their corporate tax bill and look for ways to reduce it. The pressure companies are under forces them to take a closer look at the way they are structured and at how their competitors are operating — this is where Value Chain Transformation comes in.

Value Chain Transformation, also known as Tax-efficient Supply Chain Management, is characterised by a centralisation of functions, risks and assets. This centralisation allows businesses to reduce costs and

become more efficient in the way they operate. It starts by determining what the most effective and efficient target operating model is to run a business, this is accomplished by looking at which capabilities and decisions have the greatest profit impact across the value chain. Next, the relevant key people and assets are identified and a determination is made as to how business and tax benefits can be derived from centralising these resources. The outcome will be a range of target operating models covering various processes, countries and divisions, each with their own unique business case and transformational challenge.

III. VAT

An increasing number of countries are introducing indirect tax systems whilst many EU member states, which have had a VAT system for a long time, are turning it into a larger source of revenue by increasing the applicable VAT rate. This could potentially mean that costs for businesses increase as well.

Although it is clear that governments are focusing more and more on indirect tax, companies are behind the curve in terms of restructuring projects. Discovering just how much of an impact a business restructuring project has on a company's VAT reporting obligations often comes as a big surprise.

IV. Incorporating business restructuring and VAT into a traditional operating model

The most traditional model structure is one in which the Principal Company is based in a tax-efficient country and procures goods either through contract or toll manufacturers and typically sells them via distributors to third-party customers. The goods therefore pass through the Principal Company as a purchase, followed by a subsequent sale. Such a structure has numerous VAT consequences as a result of the Principal owning goods and holding inventories in a number of different countries.

The resulting supply chains can be difficult to control, in particular since this involves logistic processes and multiple parties that are often located in different countries. Depending on (amongst other things) where the right to dispose of the goods is transferred to or from the Principal Company, as well as the physical movement of goods, number of parties involved in the chain, who is responsible for transport of the goods, and the agreed Incoterms, VAT reporting obligations might be triggered for the company at various

levels. These obligations could include VAT registrations, the filing of VAT returns and other compliance obligations.

The people tasked with administering the VAT work-stream of the project should, amongst other things, take into account the following VAT considerations:

- Is the manufacturer providing a supply of goods or services?
- Is simplified triangulation in place?
- What to choose and how to apply the appropriate Incoterms.
- What to consider for the customs/excise impact.
- What will be the VAT implication of the cost recharges?
- How to treat the reverse supply chain of goods (what will happen with goods under warranty or returned/repaired goods?).
- Could a permanent establishment be avoided in certain countries?
- What is the VAT treatment of special inter-company fee payments?
- Should a warehouse be involved? What kind of warehouse?
- How should the VAT treatment be implemented in the systems: systematically as well as VAT-specific?
- How to fulfil the invoice requirements of the jurisdictions involved.

Taking these things into consideration will allow a business to optimise its corporate tax set-up and also ensure it is operating as efficiently and effectively as possible from a VAT point of view. On the other hand, by ignoring VAT at the outset, a company will very likely face a range of disadvantages: from a negative impact on working capital, to assessments for VAT, as well as penalties or interest charges for improper declarations.

V. Trends

Several trends are emerging in business restructuring. One relates to the geographic basis of change and the other to the types of model used and their manifestation in a services context.

In the past, it was primarily US- or Europe-based companies that were focused on restructuring their businesses. Increasingly now, we see Asian companies that are also looking into supply-chain planning and

the establishment of Principal Companies in Europe.

Moreover, we have noticed an emerging trend in the various restructuring models. The traditional Principal structure is evolving and new models are being devised, each of which has its own specific VAT implications.

Besides the traditional Principal model the following models are becoming more common:

A. Single entity model

This model is built around one single company with branches to address the complications that arise under the traditional structure with many separate legal entities across a region. The aim is to reduce the number of internal transactions and associated recording and reconciliation costs. In addition, this model is characterised by single ownership of all assets and inventory and regional decision-making.

Many of the questions that arise in a single legal entity model from a VAT point of view centre on whether the principal company and its branches can be considered as one legal entity and, therefore, whether invoices need to be issued for intra-company supplies. Countries outside of the European Union do not necessarily apply the "one business" approach when it comes to the headquarters and its branches, and even within the EU some member states still have difficulties accepting no VAT being accounted for in such a structure. In addition, even where a country does consider the head office and its branches to be one single legal entity for VAT purposes, pro-forma invoices still need to be issued if goods are moved cross-border.

B. Centre-led principal model

This is in many ways similar to the traditional manufacturing/distribution model. The main difference is that in a centre-led model, the Principal company does not take title to the goods. Instead of being part of the chain through which goods are sold, the Principal provides strategic direction and instructions to the other members of its group and strips out risks. The Principal will usually issue a value-based service fee to manufacturers and distributors for its roles and responsibilities. Since the Principal does not take title to the goods in a centre-led model, the VAT implications of owning goods (e.g. VAT registrations, working capital implications of domestic reverse-charges, etc.)

do not materialise in this structure. However, it is not without its very own challenges from a VAT point of view. In the past couple of years we have seen situations where the fee that group companies have to pay the Principal for functions and risks assumed by the latter is due only if the group companies are profitable. If they are incurring losses, there may be a fee due from the Principal to the other group companies. Therefore, some of the questions that need to be thought about when a business is looking into transitioning to a centre-led model include:

- How does the Principal strip the risks and functions out of the group companies, and what does this mean in terms of VAT? What exactly is the Principal doing for the group companies?
- Is it considered a supply under VAT and what is the nature of it?
- How is the fee owed to the Principal calculated, i.e. what is the consideration for the supply?
- Are the manufacturer and distributor making a supply to the Principal? If so, what is its nature and how is the consideration calculated?
- Is there a barter supply between the Principal and the other group companies?
- Is there third-party consideration?
- Do any of the countries involved apply "use and enjoyment" rules on the supplies made?

VI. Beyond VAT

The aforementioned are only the potential VAT qualifications of the transactions. In addition, businesses need to think about how to reflect all of this in their agreements and in their ERP systems to ensure the VAT accounting and reporting runs smoothly and correctly. We frequently see businesses struggling to work indirect tax into their systems and this can be a stumbling block when the project goes live — yet another reason for taking indirect tax into account right from the start.

Companies that take a detailed look at how they are set up for VAT during the course of a business transformation exercise gain the opportunity to review how they are doing business from a strategic standpoint, and to identify opportunities for optimisation — e.g. simpler structures, an improved working capital situation, etc. Another advantage is that such a detailed review of the VAT set-up will lend a sense of where indirect tax risks may lurk, thereby enabling the company to reduce its compliance risks.

VII. Conclusion

The starting point for a business transformation project is not VAT and not even tax; rather, the primary aim is to create operational efficiencies. Yet businesses can achieve benefits by putting VAT on the agenda at an early stage.

As we all know, there is no gain without pain. VAT practitioners within companies will face various challenges before they reap the benefits of a VAT-optimised business structure. In addition to the VAT-specific factors set out above, which include multiple VAT registrations, TP/corporate tax needs versus VAT needs and working capital considerations, there are a number of other issues that commonly arise during restructuring projects and, although there are often a number of ways to mitigate these issues, sometimes it is not possible to eliminate them completely.

Frequently, a key difficulty can simply be getting the wider corporate family to recognise that indirect tax is not just a compliance issue to be dealt with at the last minute, but a key source of cost efficiency and cash flow benefit. In addition, matters such as clarity on how the structure works, making sure the knowledge is maintained in the years to come as people change positions and perhaps even leave the organisation and, last but not least, managing the change, may seem obvious but are often overlooked.

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