

Shifting the balance

The evolution of indirect taxes



Indirect taxes are a major source of tax revenues for governments worldwide and continue to grow as more territories move to more consumption-oriented tax regimes. Indirect tax policies, legislation and auditing are all under increased scrutiny by governments and tax officials.

Most businesses are reacting accordingly and are focusing on their indirect tax strategies, with a particular emphasis on ensuring compliance and achieving efficiencies.

PricewaterhouseCoopers* can help you formulate, implement and manage your global indirect tax strategy.

We have over 1600 indirect tax experts in 118 countries worldwide. Our cross-border network combines the skills of:

- Industry specialists,
- Territory specialists (who are based in and have an in-depth knowledge of the local tax regime), and
- Subject matter experts, not only specialised in VAT/GST, but also with experience in specialist areas such as customs and international trade, excise duties, environmental levies and energy taxes, e-invoicing and e-archiving and litigation.

The power of our global network comes from the fact that our network members have strong working relationships and are in daily contact with one another. It is this ability to work closely together across borders that enables us to offer our clients a truly global service.

Systematic training is provided to each of our network members to ensure the highest technical quality and excellent service delivery for our clients.

Our indirect tax services focus around three main areas: strategy & risk; margin improvement and process improvement.

Strategy & risk: We help businesses to formulate their indirect tax strategies and to monitor indirect tax policy. We have strong relationships with policymakers and tax authorities around the world. We monitor policy changes and advise clients on how those changes impact their indirect tax strategy and risk. We ensure businesses have the right processes and controls in place, aligned to their indirect tax strategy, to ensure compliance.

Margin improvement: We advise businesses on the most effective ways to reduce indirect tax costs, for example by minimising the incoming indirect tax or maximising the recovery of indirect tax.

Process improvement: The process of declaring and paying over indirect taxes to the authorities involves various steps from determining the indirect tax treatment of transactions, sales and purchase orders, the raising of sales invoices and processing of purchase invoices to the collation and submission of returns and archiving. Each element of this process can be optimised in order to increase efficiency and reduce costs. Our team can advise in each of these areas.

In summary, we are ready to help you with your indirect tax issues. We look forward to hearing from you.

* In this publication, the terms "PricewaterhouseCoopers" and "PwC" refer to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

The firms of the PricewaterhouseCoopers global network (www.pwc.com) provide industry-focused assurance, tax and advisory services to build public trust and enhance value for clients and their stakeholders. More than 140,000 people in 149 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

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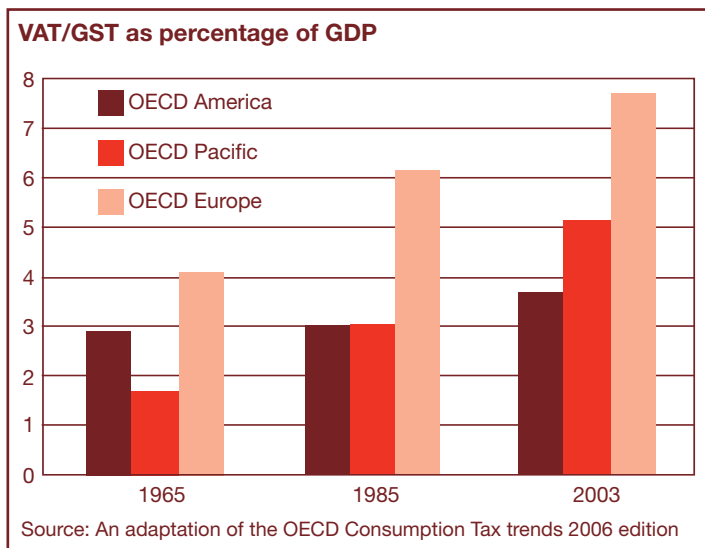
Overview

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Reviewing the indirect tax systems around the globe is very much an exercise in looking to the future. There seems little doubt that VAT and GST are emerging as the taxes of the future, and the shift from direct to indirect taxation is a fast-developing reality in many of the countries and regions that we analysed for this document. The graph below shows how VAT and GST have increased over the years, as a percentage of GDP:



Some countries are at the very starting point of creating and implementing their VAT or GST systems. We see this movement strongly in the Asia Pacific region, with Malaysia's planned introduction of VAT and India's move to a unified GST across the whole sub-continent by 2010. Plans for new VAT systems are developing elsewhere in Asia Pacific, with Laos for example expected to introduce VAT in 2008.

In the Middle East, we see the Gulf Cooperation Council countries moving steadily towards the adoption of VAT systems and it is highly likely that all members of the GCC will, in the next five years, have fully functioning VAT systems of one form or another. The global map of VAT and GST is gradually filling up – and even in the space of the last 18 months, has evolved considerably (see pages 9 and 10).

Responding to global challenges

These days, the issue of globalisation is never far from the dilemmas and challenges that operating a successful indirect tax system creates. Where VAT and GST systems are already well-established, such as in the European Union, we also see developments that respond directly to the need to make sure that economies can prosper in an increasingly competitive global environment. This means that direct (corporate taxes) are being reduced at the same time as the VAT base is broadened. In other parts of the world, rates of VAT are increasing. For example, Singapore has announced its intention to increase its rates from five to seven per cent, effective 1 July 2007, with a further rise posited for the future, accompanying reductions in the corporate and income tax rates. In Canada, at face value, the opposite seems to be taking place, with a reduction in the rate of federal GST. However, by lowering the rate, the government is arguably also making tax collection more effective and therefore the decrease is likely, in the end, to mean an increase in collections and consequently revenue.

In light of the perceived shift from direct to indirect taxation there is a further challenge not to be forgotten.

VAT and GST systems can be regressive in nature, and also potentially inflationary. There is an argument therefore that when implementing indirect tax systems, governments should consider introducing measures which will ensure a level of welfare for the lower paid, including the potential for the application of reduced tax rates, or even zero rates for basic goods and services (food, medical supplies and aids for disabled people). In this regard it is interesting to note a report issued earlier this year which has been researched by PwC UK for the Chartered Institute of Taxation in the UK. The report specifically calls for VAT reliefs to be extended for disabled people and for these to be consistently applied across the European Union.

There is also much evidence of moves to tackle global challenges within the customs arena, where issues such as safety and security and the facilitation of international trade are at the forefront.

The need for convergence

As the world becomes increasingly global there are consequences for the way that national tax systems interact to create the possibility of double taxation and inhibiting economic activity. In a simple sense, we see this happening in Africa as people living close to borders who wish simply to buy and sell on a basic level find themselves penalised through double taxation.

On a more complex level, there is the challenge of large enterprises operating in an ever more global environment. This informs the present debate on the cross-border supply of services in the European Union. This is of course a major issue for

OECD – Best practice benchmarks for VAT/GST

Neutrality	neutral and equitable between forms of commerce
Efficiency	minimisation of compliance and administrative costs
Certainty	anticipation of tax consequence for business
Effectiveness and fairness	right amount at the right time
Simplicity	no burden to business – easy to apply
Flexibility	keep pace with technological and commercial developments

the European Commission and the OECD on an international basis. PwC firms are contributing to discussions regarding place of supply rules in order to ensure that the current lack of synchronisation and convergence in the rules applied at a national level does not create a significant cost for doing business in a global environment. It is imperative that all parties – business and government – are able to work towards trying to create some firm consensus on standards that can operate internationally.

The need for convergence is also a priority in terms of customs policies and procedures, particularly in relation to the certifications that different countries and regions are establishing to verify the reliability of businesses and their compliance with safety and security standards. The most immediate need we see at present is for a harmonised introduction of the AEO certification in

the EU and convergence between the US C-TPAT certification and the EU AEO certification, so that there is mutual recognition from one country to the next.

In addition, within the EU, a new Customs Code, anticipated for 2009/10 seeks to harmonise and simplify customs procedures, and a number of moves are already being taken towards achieving this.

Creating efficient and effective tax systems

Reviewing and comparing systems on an international basis demonstrates that no system is without its flaws. The OECD has issued best practice benchmarks for VAT or GST systems, which are illustrated above.

However, if we compare the various systems, there is a clear tension between the need to eliminate the possibility of non-compliance and fraud, and ensuring the burden of administration on taxpayers does not impair their ability to compete. In the more recently introduced VAT and GST systems, such as those in Australia and Singapore, we tend to see far fewer opportunities for fraud and high levels of compliance. In contrast, one of the major fraud issues in the European Union, the so-called missing trader, or carousel fraud, is causing significant concern and there is wide-ranging debate about the best means to address it.

A suggested response to this problem has been to apply a reverse charge so that the burden of administration falls on to the taxpayer. There is a danger excessive administration will be placed on companies that already see themselves as unpaid tax collectors for VAT. In response to this, the work underway at the European Commission (to which PwC

firms are contributing) aims to ensure that a detailed and reasoned debate takes place that not only seeks to address the problems associated with missing-trader fraud, but that also places the issues in the context of a highly competitive and rapidly globalising business environment in which the competitiveness of the tax system is part of a broader picture of global economic competition.

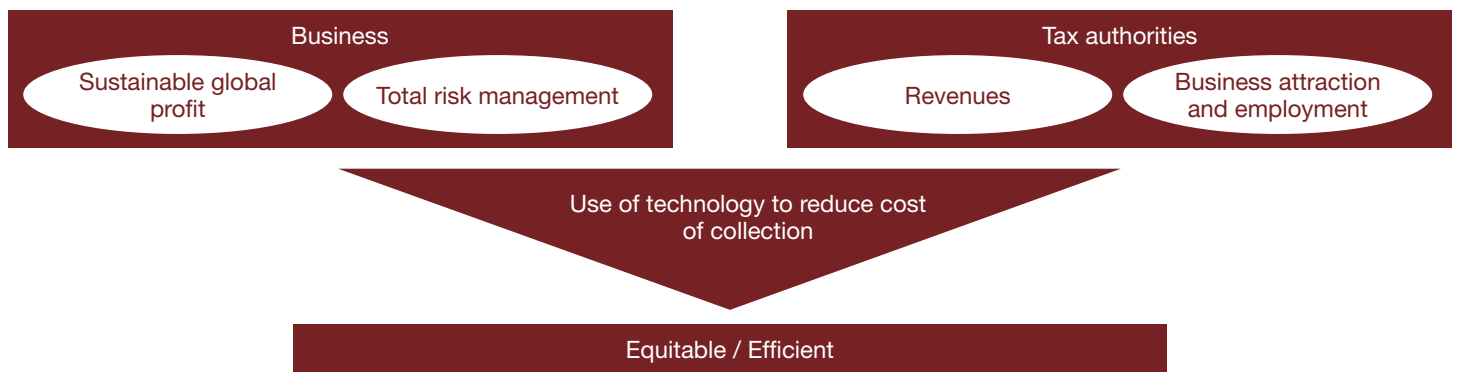
Again while recognising the need for systems to have the goal of minimising complexity, there must also be an awareness of a need for an appropriate balance to be struck to allow economic and social objectives to be accommodated.

In the context of these issues, it is important that all contributors to the debate, including governments, business and advisors, are able to bear in mind the wider strategic implications of the conclusions that are reached. All the stakeholders in this debate need to understand these wider economic ramifications. This in turn requires them to be open to change, to have patience, to enter dialogue and make sure that the analyses they rely on in their decision-making processes are detailed, accurate and well-informed.

Responding to change

Another challenging issue for many of the VAT systems that we profile in this document is in the realm of financial services. The world has moved on since the original legislation framing the practice of financial services was introduced. Within the EU this poses a distinct threat to competitiveness for financial institutions that wish to make use of outsourcing back office functions within the EU. PwC firms have been

VAT/GST systems as “Win-Win Taxation Model”



working with the European Commission on providing some detailed analysis of the economic impact of the current regime as it applies to financial services, and there is again here a clear desire to make sure that the European financial services industry is not disadvantaged by the VAT system.

Technology to move forward

Our analysis of indirect tax systems around the world shows that technology is having an increasingly important role in the creation of effective and efficient tax systems that benefit both taxpayers and the tax authorities.

In the customs arena, there are definite moves towards a paper-free customs environment. The trend is currently most evident in the US and EU, however

various countries in Asia Pacific are also looking to technology to modernise and streamline customs requirements and to enhance the safety and security of trade flows. In the EU, for example, legislation now already implemented as a precursor to the new Customs Code, which is under development, will use electronic data exchange as a starting point, so that pre-arrival and pre-departure information requirements (obligatory in the EU as from July 2009) can be exchanged between the customs authorities, and eventually between customs authorities worldwide.

Since 2004, the OECD has been examining data collection and electronic auditing with a view to creating a standard audit file that would enable businesses to provide information from within different ERP systems without the need for the additional expense and

disruption that would otherwise be required to meet tax authorities' requests for electronic information. Again, PwC firms have been closely involved in this work, co-chairing an OECD committee that comprises representation from business and government, working towards creating an acceptable standard for all parties.

The need to move towards standardisation is particularly important if the inefficiencies and costs of multiple standards are to be avoided and again is an area in which mutual interests are likely to be best served through cooperation and open dialogue.

Conclusion

For indirect taxes to evolve they need to balance the revenue-raising abilities of government with the need to ensure that businesses do not become overwhelmed with the burden of tax collection. In more established VAT systems – such as the EU – there needs to be a willingness to learn from the successes of other countries that have more recently implemented VAT or GST systems and to create effective and efficient systems that create a true 'win-win' for governments and taxpayers alike. A typical VAT or GST system as 'win-win' taxation model is depicted above.

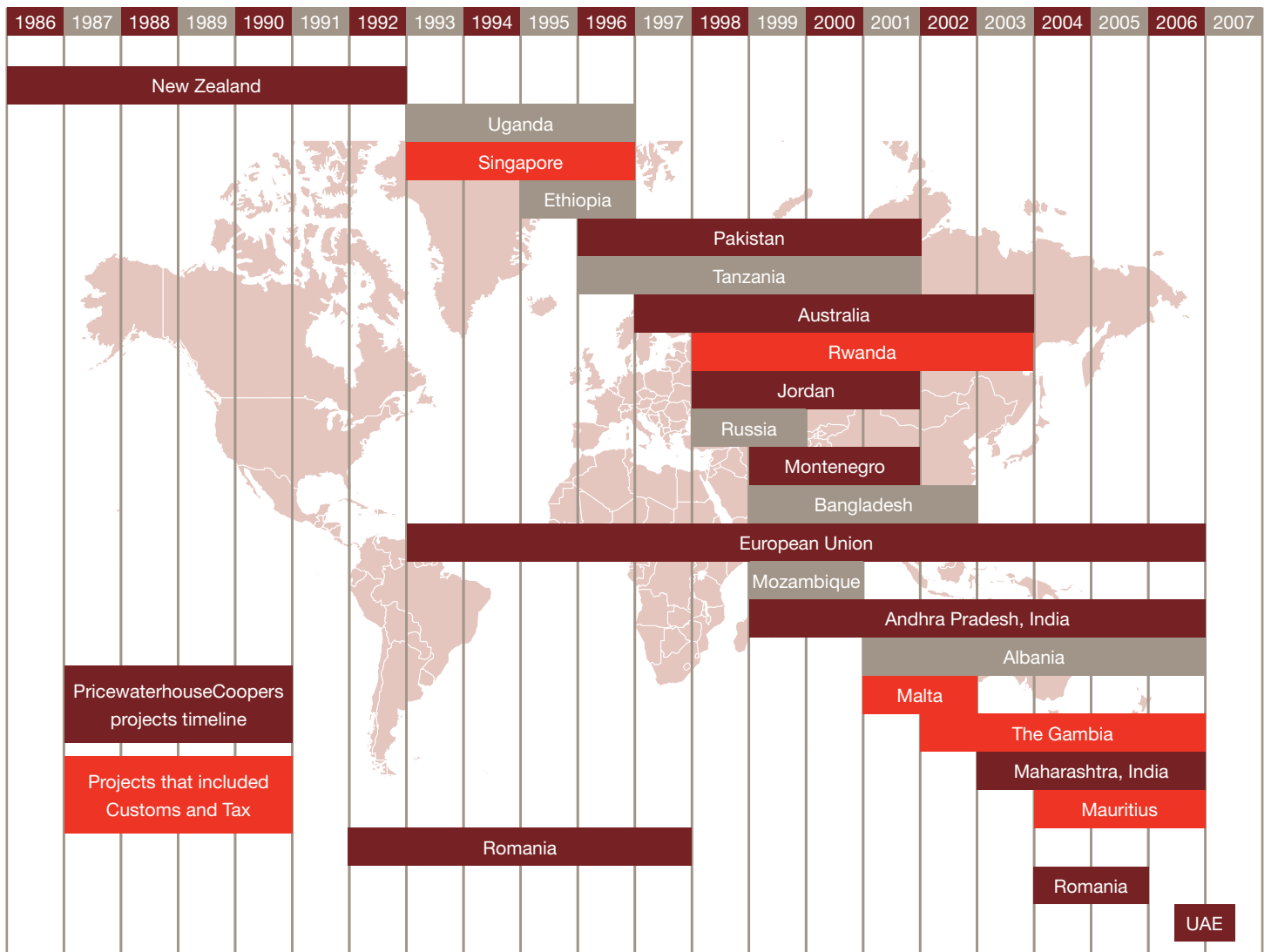
Indirect tax systems will continue to evolve and emerge in the future and it is in everyone's interests – taxpayers and governments alike – to ensure that the future is decided by constructive and engaged dialogue and debate, and to recognise that both social and economic objectives can also be accommodated in the evolution of indirect tax systems. It is a debate in which PricewaterhouseCoopers is already heavily involved

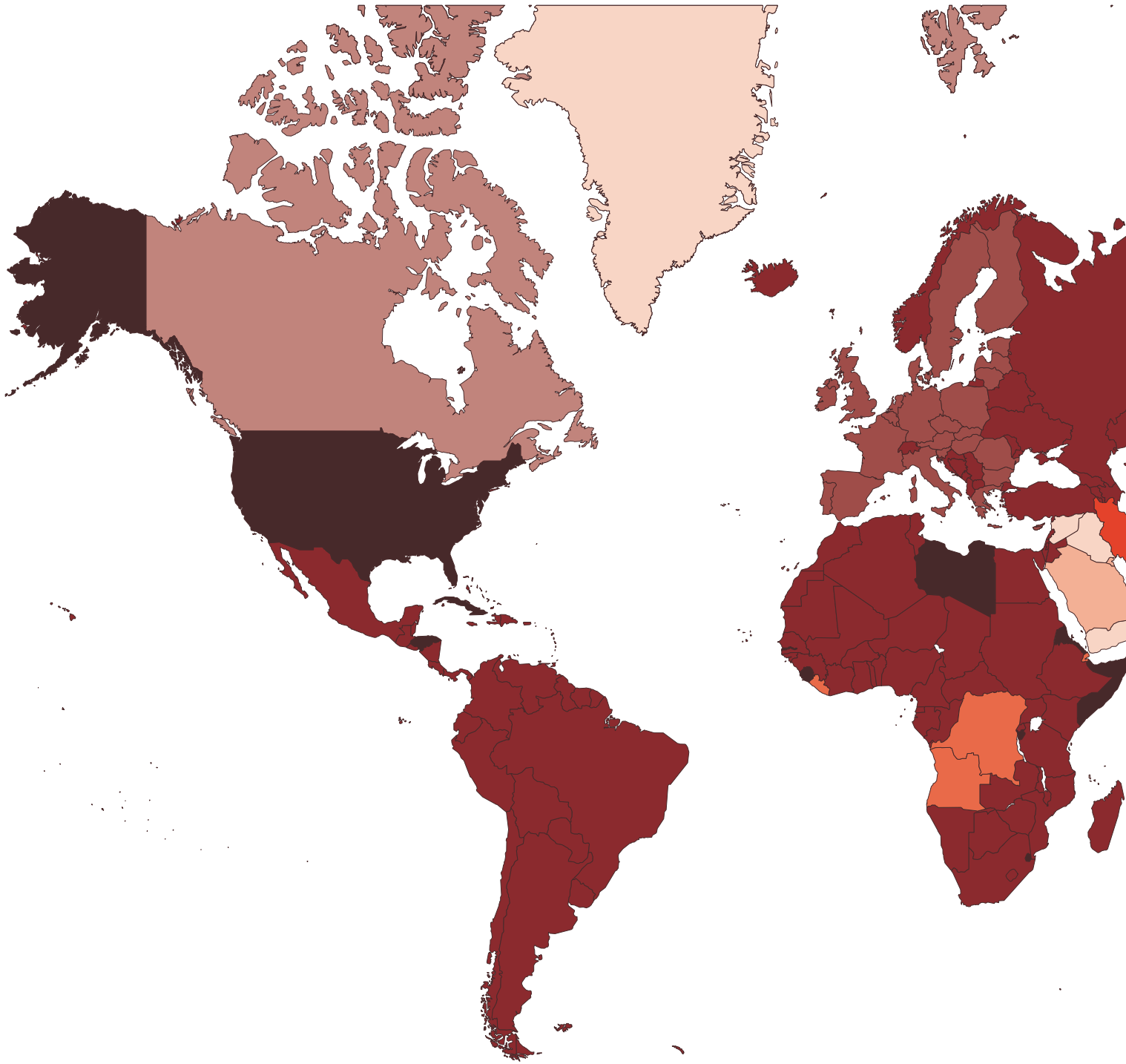
and which will continue to be a priority for us over the coming months and years.

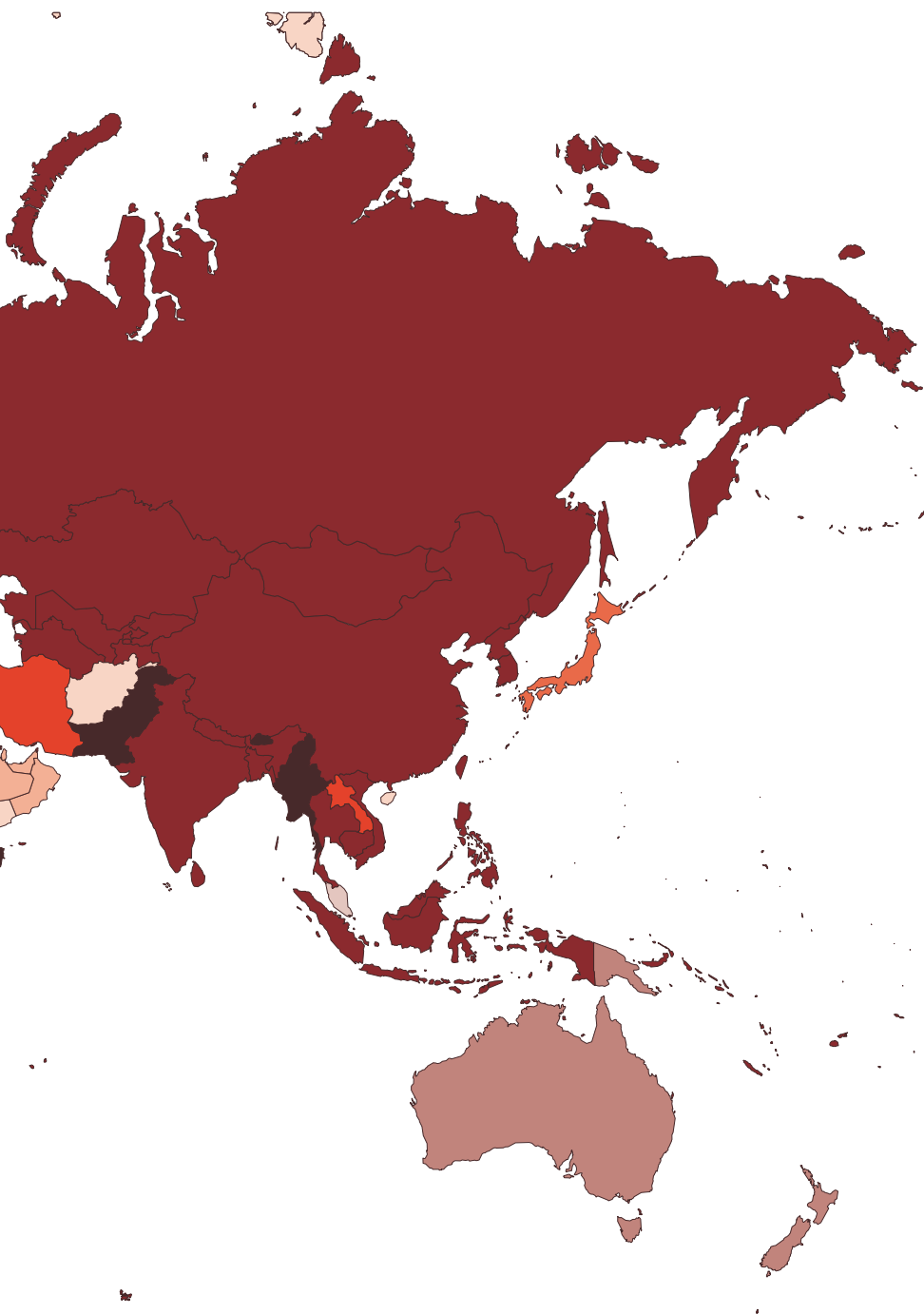
Our network helps to identify and share best practices. We work with stakeholders across business and government to help shape the taxes of the future that allow all stakeholders to achieve their long-term aims.

This document provides an overview of the status of indirect taxes by presenting information on key regions and countries. Following on from our 2006 publication, QuoVATis, we hope this provides a useful reference for any party engaging in the debate around the future of indirect taxes.

PricewaterhouseCoopers VAT/GST projects for governments – last 30 years







- Existing VAT systems
- EU VAT system
- GST system
- Future GST system
- Future VAT system
- General consumption taxes
- Considering a VAT system
- No GST/VAT system or consumption taxes
- Sales taxes

The OECD's view of
the shift from direct to
indirect taxation

Jeffrey P Owens,
Director, Centre
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There has been a revolution in the tax world. Over the past 50 years, the number of countries operating a VAT system has grown from relatively few to 141. VAT has also grown considerably in terms of its contribution to revenue – from around 13 per cent of total revenues a quarter of a century ago, it now stands at just under 20 per cent today. VAT has been used as a substitute for revenues which originally came from customs and excises and from specific taxes on consumption. So although there has been a switch from direct to indirect taxes, it is more that the structure of the indirect tax system has developed. As a consequence, VAT has become more of a priority in terms of the OECD's work programme. The key issue is trying to ensure that all the different VAT systems interact in a way that avoids double taxation and double non-taxation. This is a real challenge given that there are as yet no internationally agreed standards. In fact, one of the main roles of the OECD is to try and develop some international standards and to monitor their implementation, as well as providing an effective mechanism for resolving disputes as they arise.

One of the reasons that governments regard VAT as an attractive option is because it provides a better balance between direct and indirect taxes. And an analysis of the total cost of administering the VAT system shows that it is one of the most effective mechanisms for governments to raise large amounts of revenues. Compared to corporate income tax, for example, VAT is a much more cost-effective mechanism.

The role of the OECD

All but one of the OECD member countries – the United States – now has a value added tax system. In response

to this, the OECD set up a group around eight years ago, to look at consumption, sales and value added taxes. Initially, the focus of the group was around the important question of the application of VAT to e-commerce as Commissioners were concerned about the impact of e-commerce on the tax base. Fortunately, over the last five years, it has become clear that the fears of tax base erosion were exaggerated. Today the focus has moved from purely e-commerce to consider cross-border trade more generally. Consequently, the work carried out in the e-commerce area, particularly the 1998 Ottawa Taxation Framework Conditions, has been expanded into the whole services sector. The next stages of work will involve developing the two principles issued in 2006 – that taxation should take place in the jurisdiction of the customer and that VAT should not, in general, be a tax on business – to create a set of guidelines to ensure the principles are applied in a consistent fashion. However, agreeing on the principles is likely to be the easiest part of this. What will probably prove more difficult is agreeing their consistent application by all parties, as is the case with the application of the 6th Directive in the EU. The group will also explore whether a Model VAT Convention is needed. At this stage it is unlikely that member countries are ready for that. However, the key point is that with so many countries having a VAT, there is a clear requirement for some agreed international standards.

The initial focus then is on the services sector, with a particular emphasis on cross-border services, as this is the most challenging area. For cross-border activities, it is much more difficult to apply VAT in the area of services and intangibles. This also holds true

for corporate income taxes. A working group, with business representation, is developing guidelines for the application of the principles, with the expectation that they will start to be issued in 2008.

Addressing costs with electronic auditing

The objective of minimising costs for the taxpayer and the tax administration is critical. E-auditing can deliver both lower compliance costs and lower administrative costs. An e-auditing project has been in progress for over two years, though the fact that it is perceived as highly technical can make it hard to summon up interest among Commissioners. Essentially the project is concerned with how to manage information to ensure that it is provided in a standard format. Getting this right creates a win-win situation as both business and government will benefit. Over the next six months this project will be raised to Commissioner level in order for them to see how the e-audit project fits with the strategic view of their tax administrations.

Customs duties – bringing valuation methodologies together

In the 1970s, much of the work the OECD carried out in the tax area focused on excises and customs duties. However since then, very little work had been done on customs, until a joint conference with the World Customs Organisation (WCO) was organised in 2006, with a second meeting taking place this year. From the perspective of business, there is no reason why there should not be more consistency between the valuations used for customs and VAT purposes and those used for corporate income tax purposes.

Although it does not follow that the same valuations will be reached for each purpose, it should be possible to explain the differences where they occur. Part of the problem is that the customs approach lags behind the other methodologies. The 1979 OECD Transfer Pricing Guidelines are still being applied for customs, whereas direct tax uses the OECD's 1995 Guidelines, which are continuously being updated. There is probably a need, therefore, for customs to update the methods with which they undertake their valuations, and particularly the valuations of transactions within a multinational, to bring them up to date with those used for direct tax purposes. In this regard, the 2006 meeting represented a major step forward. A joint programme with the WCO was agreed, and the OECD will continue to work on strengthening its cooperation with the WCO to achieve greater consistency between valuations for customs, VAT and corporate income tax purposes.

The OECD perspective on the way forward

Consumption taxes, particularly VAT, will remain a major source of revenue for government. It is therefore imperative that a great deal of thought goes into the design of those taxes, and how they interact internationally. With 141 countries around the world now operating a VAT system, potential for double taxation is high. As a result, international cooperation is vital in this area. The standards discussed above need to be agreed.

The EU needs to reflect on the kind of VAT systems it would like to see in 10 years time. With VAT being such a major part of the community legislation, this is a key question for the European Union. It also raises the

issue of whether certain aspects of the design of the current VAT system are contributing to the problems we now see in terms of carousel fraud and aggressive tax planning.

However, it is also very important that long-term design issues are not driven simply by compliance concerns. One of the challenges is whether the Community has the capacity to step outside of the 6th Directive framework to challenge itself as to whether it would design the system in the same way today. Answering that question means drawing upon the experience of other countries, like Chile, Singapore and New Zealand each of which looked at the experience of the EU when designing their own VAT systems. There is no reason why the EU itself should not now learn from their experiences. One of the lessons learned is the need for a broad-based, low rate VAT. A VAT rate of 25 per cent creates a powerful incentive for business to engage in aggressive tax planning, and for others to engage in tax fraud. If you have a VAT rate of 8-12 per cent, there is far less incentive. VAT rates outside Europe are almost half those within Europe. The debate within the EU therefore must move to the next level, focusing beyond what special regimes can be designed for French restaurateurs, Danish cobblers, Dutch bicycle makers or even Lithuanian hairdressers. The questions have to become much broader and examine how to redesign the base and the rates in order for the region to remain competitive in today's international business environment.

Moving towards flatter taxes

The business environment today is more competitive than even a few years ago. This is forcing governments to question whether their tax system is sufficiently competitive. Many governments have concluded that their systems are not sufficiently competitive, which is why there has been a dramatic fall in corporate income taxes. 15 years ago many countries had corporate income tax rates of more than 45 per cent. Today, rates are rarely higher than 35 per cent. 15 years ago marginal top personal income tax rates were frequently above 70 per cent; today it is rare to find them above 40 per cent. So there has been a continual reduction in the nominal rates. In March, the UK announced a two per cent decrease in its corporate income tax rate, a trend which is likely to continue. But it needs to be accompanied by a widening of the tax base. The 'mantra' of tax reform should be: 'broad base, low rates'. The main feature of the flat tax debate is not about having one single rate of tax, it is about widening the tax base. When Slovakia or Russia moved towards a flat tax, the key features involved completely removing most of the incentives and special provisions within the previous tax base, in order to achieve simplicity. The key challenge in the flat tax debate is whether it is possible to maintain some progression within the system. The flat tax debate is highly relevant to VAT because of the objective of moving towards flat VAT rates, i.e. a broad-based VAT with a single rate.

Jeffrey Owens was interviewed on 2 March 2007

Customs overview

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Three key themes are driving developments in customs policies and practices around the world. These are:

- Safety and security;
- E-customs (the modernisation and computerisation of customs regulations); and
- Trade facilitation.

Of course, each of these issues is interrelated and each influences developments in the other. Some developments are taking place more rapidly in certain regions, while priorities in others dictate that other issues are receiving more attention. Overall, it is clear that significant changes are occurring to the way in which international trade is administered and controlled. As a result of these changes, all companies trading beyond their national borders will need to prepare and respond accordingly.

Safety and security

Since the events of 11 September 2001, safety and security, and particularly the threat of terrorism, have driven developments, especially in the developed markets of the EU and the US. Customs has, in effect, become a focal point for securing the movement of goods and increasing border safety.

In the US, a number of initiatives arising from the Homeland Security Act have created a new regime for international trade into and out of the US. In particular, a programme called The Customs and Trade Partnership Against Terrorism (C-TPAT) contains a new set of standards that aim to create certification that will allow businesses to demonstrate their reliability

and compliance with safety and security standards. However, given its very nature, international trade standards require international cooperation and therefore, the World Customs Organisation (WCO) has created a programme – The Framework of Standards to Secure and Facilitate Global Trade (SAFE) – that contains a number of protocols and standards relating to safety and security. The principal concept within the SAFE programme is the Authorised Economic Operator (AEO), a standards-based system of certification that validates and authorises a company as a reliable trade partner. The concept of the AEO is not restricted to the physical security of trade flows, but also extends to administrative processes, such as risk management, internal controls and staff policies. In this way, the full range of activities associated with trade are taken into account.

The European Union has developed these principles into its own AEO legislation and this will take effect from 1 January 2008, when companies will be able to apply for AEO status. The principles underlying this status are very similar to the aims of the US' C-TPAT. However, there are some differences between the two that companies should be aware of. Both C-TPAT and EU AEO status apply to participants along the entire supply chain. In other words, all parties playing a role in international trade – shippers, manufacturers, receivers, transporters and so on – are covered. However, whereas the US C-TPAT requires that all linked entities are checked in order to receive certification (e.g. EU subsidiaries of a US business will be subject to simultaneous checks in order for the US business to receive certification), the EU AEO legislation requires that each separate link in a supply

chain is separately certified, and this may create some challenges with implementation. Another difference is that the EU has applied the certification as an AEO not only to the aspect of safety and security, but also to the generic reliability of companies to be granted simplified customs procedures. The extent to which this will be enforced in practice, depends upon the new modernised customs code, yet to come (see E-Customs section below).

Experience and perceptions from the US suggest that companies who have elected to receive C-TPAT certification have benefited from less inspection than their uncertified counterparts. In the EU, rather than a formal requirement being imposed, the expectation is that the market will create commercial imperatives, much like ISO standards, that will encourage businesses to apply for certification. It is likely that from a commercial and trade facilitation point of view, EU companies will wish to adopt the AEO concept. However, in doing so, they will need to make sure that they understand what it means for them, and that they prepare a detailed implementation plan to make sure that the process is as efficient and effective as possible. The standards on both sides of the Atlantic (and eventually all around the world) will become mutually recognised, so that certified status from one country will automatically be recognised by others. The WCO is assisting with the development of mutual recognition, and dialogue between countries is likely to help ensure that a common set of standards is agreed that will facilitate the safety and security aims of initiatives such as C-TPAT and AEO, for many countries around the world.

E-Customs: modernisation and computerisation

Securing international tradeflows is part and parcel of a wider effort to modernise customs regulations in order that those flows of goods can become as efficient as possible. To that end, the EU has been working on a new Customs Code that is designed to address some of the challenges that the implementation of the present code by individual member states has created. The now 27 different member states are theoretically bound by a single code, but in practice, operate with 27 different local interpretations and practices on how to apply the procedures – a problem that has been the subject of complaints by the US to the WTO in the past.

The new Customs Code (anticipated for 2009/10) seeks to harmonise and simplify customs procedures. As a precursor to the introduction of the Code, new legislation was adopted last year, to manage the safety and security processes, to enhance the possibility for data exchange and to computerise customs declaration entry systems. Based upon this legislation, companies will be able to apply for AEO status for their adherence to customs procedures, as well as for meeting safety and security standards, as discussed previously. Member states are presently engaged with the implementation of this new framework that the Commission has created. The broad spread of customs administration experience between the 27 member states means that some are struggling with definitions and the practical application of the rules. There is, therefore, a danger that the heterogeneity of practices we see today will be replicated. A number of parties in the market (including PwC firms) are trying to establish dialogue with the Commission to ensure that

uniformity of application can be achieved within the member states.

Achieving this uniformity also requires a second step – customs automation. This goes beyond the automation of the customs entry process and requires significant data exchange between different customs authorities worldwide. The EU is working to ensure that information can be exchanged between member states and, in due course, with other customs authorities around the globe. As from 1 July 2009, companies in the EU will have to submit to customs a data-set on goods arriving in the EU, prior to the actual arrival, and for goods to be shipped, prior to shipping (the so-called pre-arrival and pre-departure information). This will provide customs with the basic information on the goods in advance, allowing them to make a preliminary check on the data, and to manage flows of goods more effectively by sending information on to the receiving body. Exchanging data on a much broader basis means that customs has to develop a standards-based interface set to ensure that all companies can supply information that can be read by all customs' systems.

As the above demonstrates, these developments are, at present, largely restricted to the developed markets of the EU and the US. However, some countries in Asia Pacific such as Hong Kong, Australia, Japan and Singapore, are working on protocols and programmes to modernise and streamline customs, as well as to enhance the security and safety of tradeflows. The movement towards a 'paper-free' customs environment may be more advanced in some parts of the world than others, but there is little doubt that more and

more countries are moving into electronic customs declarations and that the rapid advances in information technology will bring that reality to the world sooner rather than later.

Trade facilitation

While the security, safety and efficiency of trade flows may be the priorities in some regions of the world, as outlined in the sections above, there is little doubt that facilitating mutually advantageous trade arrangements is the number one priority for many countries in the developing world. Although trade facilitation encompasses more than customs alone, and includes issues such as logistics and economics, nevertheless, customs has a critical role to play, as one of the most important tools to facilitate trade is the use of preferential customs duties.

Although preferential customs regimes were traditionally offered to developing countries by the more developed countries, they are now increasingly agreed between developing nations. The origin of goods is determined either by the country where the product is fully grown or manufactured, or the country where substantial work on that product is carried out (meeting the standards set in the preferential agreements over eligibility for the preferential duty rate). This then creates the conditions to grant preferential status and to qualify for reduced or zero rate of customs duties between those trading partners.

As said, a number of years ago, this was mainly granted as a form of subsidy regime from the developed world to the developing world, particularly the least

well-developed. Now, the number of preferential trade arrangements is exploding between developing countries themselves, and this could potentially have a significant impact on companies' sourcing strategies.

When sourcing raw materials and intermediate products, it is possible to benefit significantly from making the right choices in the supply chain in terms of the origin and destination of raw materials and intermediate goods for further processing. As these preferential arrangements take hold, we are seeing a gradual and inexorable lowering of duty rates. Although the further rounds of the GATT are facing challenges, unilateral and bilateral agreements are seeing levels of duty reduced, and in many cases, abolished completely.

All the trends highlighted above point to a new set of issues and challenges for customs. The focus is moving from the tax planning arena towards compliance and trade facilitation, whereby the emphasis is on moving goods across borders without delays and in the most efficient way. Of course, the extent and strength of that development varies from region to region, but companies should make sure that they remain up to date with developments in what is a highly dynamic area.

The move from direct
to indirect taxes – a
view from Belgium
Didier Reynders,
Minister of Finance
for Belgium



Belgium operates with a relatively high level of VAT – 21 per cent – which is higher than most of Europe, apart from some of the Scandinavian countries. Unlike the case elsewhere, it has been possible to lower direct taxation without having to raise indirect tax rates. Belgium has introduced reforms to create a lower level of direct taxation without any change in the indirect taxation. The reason for this is that there has been a very heavy tax burden in Belgium. By decreasing direct taxation on incomes and corporate taxation it is possible to create more jobs, encourage more economic activity and as a consequence, receive higher receipts from indirect taxation – from VAT, from excise, or from others – without any change in tariffs. So while it is easy to see why other countries, such as Germany, have pursued the route of lowering direct tax and raising indirect tax rates to compensate, in Belgium with such a high level of tax burden it has been possible to introduce some tax cuts without any corresponding change in indirect taxation. In Europe more generally, Belgium is a strong advocate of the need to achieve tax harmonisation, without the imposition of uniformity, arguing that open discussion within the European Council and the Commission is the appropriate forum for this rather than relying on European Court of Justice rulings.

Negotiating the reverse charge

As a transit country for a great many types of goods and services, carousel fraud is an important issue for Belgium and there has been some success in combating VAT fraud. Belgium is interested in entering negotiations to lower the level of VAT charged on

restaurants to six per cent. Introducing the reverse charge as a method to combat VAT fraud may feature in negotiations with countries such as Germany and Austria that have opposed lowering the VAT rate for restaurants, but wish to introduce the reverse charge. Though there are some reservations in Belgium about the extent to which the taxpayer should bear the full burden of the reverse charge, it is likely that these will be overcome provided that the reverse charge is an optional rather than mandatory obligation for member states.

The challenge of simplification

Administrative simplification was one of the main aims of the German Presidency and is a goal widely shared by member states, including Belgium. However, it is challenging to achieve this in the VAT system alongside accommodating taxpayers' demands for specific tax cuts and incentives for particular industries and business contexts. Introducing specific measures inevitably creates more complexity, and this runs contrary to the taxpayers' demands for simplification.

Belgium has responded to taxpayers' demands for a more competitive tax regime by lowering corporate tax rates, but also recognises that there needs to be a balanced approach so that administrative burdens on companies can be reduced in line with lower rates of taxation. This needs to be conducted at a European level so that the administrative burden on companies can be uniformly reduced across the EU.

In Belgium, the Ministry of Finance works alongside the Secretary for Administrative Simplification, and

is drafting new, simpler legislation that addresses some of the complexity inherent in the texts that it is replacing. Technology is also being used so that taxpayers are able to interact more effectively with the tax administration. The tax administration systems are being integrated to create a one-stop solution for taxpayers so that their information is accessible across the whole tax administration process. This greater availability of information within different parts of the administration also needs to be balanced against the need for privacy.

Implementing technology

Belgium is placing considerable emphasis on the ability of technology to address the efficiency and effectiveness of the tax administration. Accordingly, budgets for IT have quadrupled in the last eight years, from 40 million Euros in 1999, to 160 million today. As well as building audit models in accordance with OECD guidelines, the Belgian tax authorities are using technology to carry out detailed risk assessments of particular sectors and activities. This means developing in-depth analysis that in turn allows the tax authorities to identify specific issues that need to be addressed within particular sectors.

New measures for a new Belgian tax environment

Belgium has introduced a number of measures that are seen as providing considerable benefits to the business community. The introduction of notional interest deduction places all equity financing on a level playing field. VAT grouping has also been introduced and this is seen as the start of a process to reform corporate

taxation whereby related entities will be able to operate on a grouped basis for all taxation. These measures, along with the considerable reduction of Belgian corporate tax rates, are seen as being just as important for small and medium-sized businesses in Belgium as they are for multinationals.

Future tax policy goals: an international perspective

The indirect taxation system in Europe needs to keep pace with the changes in the global economy and the increasingly competitive nature of developing economies, particularly China. Ensuring that taxation evolves in line with these competitive pressures is likely to dominate tax policy making in Europe in the foreseeable future.

Looking further ahead, key policy goals, such as environmental protection, could be addressed effectively with indirect taxation measures that go beyond the aim of simply adding to national budgets, but are used to shape the way in which businesses and consumers behave. International action is vital to secure those aims and global cooperation will be necessary to use taxation as one of the levers to achieve environmental policy goals such as those enshrined in the Kyoto Protocol.

Didier Reynders was interviewed on 10 April 2007

Africa

What are the main relevant indirect taxes?

Africa's scale and diversity means that it is highly unlikely that a harmonised system of VAT comparable to the European model is anything other than a distant prospect. More pressing problems than the harmonisation of indirect taxes need to be addressed first. However, VAT regimes have been introduced in many African countries and the World Bank and the IMF are strongly advocating its adoption by countries that have not already done so. But while an Africa-wide system is unlikely, greater harmonisation and coordination for VAT policies between smaller groupings of countries and trading partners is perhaps a more realistic vision of the future of indirect taxes in Africa.

The IMF has for a number of years been promoting the adoption of VAT systems by countries in Africa. Most African countries apply a destination-based VAT, designed to encourage cross-border trade and investment. Cross-border trade in Africa takes many forms, from the largest multinational groups to individuals living near a border who may cross into a neighbouring country to do their shopping. This can give rise to double taxation. Unless specific double taxation agreements are drawn up to deal with this possibility, double taxation at border posts will be routine. But it is not only individuals who are caught in the problem of double taxation. Practical problems with the documentation required to demonstrate zero-rating of exports often means that in practice tax is charged unnecessarily. A tension between theory and practice is a feature of much of the problems with VAT in Africa.

In addition to VAT there are also a broad number of other taxes, levies and duties. Among these, environmental taxes are likely to become an increasingly prominent part of policy making, but their rate of adoption varies considerably between countries and will develop over time. In South Africa for example, the items that are being targeted for environmental taxes and levies are consistent with the same lists being compiled by others around the world.



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Examining the way in which indirect tax operates in Africa is a complex task. This chapter, therefore, will look mainly at some of the developments and challenges that South Africa's 16 year-old VAT system is subject to and where possible draw out the inferences for the VAT systems that operate in other parts of the continent.

Significant recent developments:

This section deals exclusively with South Africa

In South Africa there have been two major VAT policy changes. The first of these relates to the VAT dispensation for municipalities (local authorities) in South Africa. Where previously municipal rates (local property taxes) were exempt from VAT, they have now been zero-rated and this has addressed problems arising from apportionment (partial exemption).

But the most significant change in South African VAT is in relation to binding rulings. From its inception, the VAT system has operated on the basis that a ruling issued by the South African Revenue Service (SARS) was considered to be binding (provided of course that other conditions such as complete disclosure were met at the time that the ruling was issued). That certainty has now been effectively withdrawn. This has had the effect that any party pursuing a ruling or seeking to rely on a previous ruling now needs to seek its renewal.

From a legislative point of view, all previous rulings expired on 31 December 2006. However a binding ruling has been issued that gave businesses the opportunity to have previous rulings reviewed. This has some very broad implications. South African VAT legislation was introduced with certain entrenched principles from the outset, and these were accepted as the basis for practice going forward at the time and have been applied. There is now a question about what happens now in terms of those entrenched principles and the extent to which they can be relied upon as the basis for operations and tax arrangements on an ongoing basis. The situation remains fluid. The principles upon which companies have relied are now open to challenge

by the revenue authorities and consequently, these are very much the focus of attention. It is likely that certain types of binding rulings will not be renewed as policies, circumstances and contexts have changed in the intervening period from the early days of the VAT system. Companies that have relied on these rulings will no longer be able to do so and may well have to review their tax practices and policies in line with the new principles that emerge.

Though not a policy development, there has undoubtedly been a marked development in the professionalism, efficiency and aggression of the approach adopted by the SARS. This has manifested itself in audit and a focus on particular areas. Of particular note is that the calibre of staff employed by SARS is changing. Whereas practitioners rarely moved from private practice to the revenue authority, the flow is almost now in the opposite direction, and the revenue authorities are now increasingly seen as an attractive employer.

Is there a shift from direct to indirect taxes?

Of the 53 countries in Africa, 40 have thus introduced VAT systems as shown in the table opposite. Given the other economic variables in many of these countries, it is hard to say whether the adoption of VAT relates to a move to greater reliance on indirect or more simply a desire to address a taxable base that often resides outside the formal economy. However, the IMF and the World Bank have also greatly encouraged the adoption of VAT systems throughout Africa.

In South Africa, the current ratio of indirect taxes to direct taxes is 42.6 per cent to 57.4 per cent. The three main tax instruments – personal income tax, VAT and company income tax – account for about 80 per cent of gross tax revenues. Of the three, VAT is regarded by South Africa's National Treasury as having been the most stable source of revenue. Strong economic growth, high commodity prices, domestic demand and buoyant consumer spending have contributed to robust VAT collection, above budget estimates.

VAT systems in Africa

No	Country	Standard VAT %	Lower VAT %	Higher VAT %	Other tax levied in addition to VAT or alternative to VAT
1	Algeria	17	0; 7		
2	Benin	18			
3	Botswana	10	0		
4	Burkina Faso	18			
5	Cameroon	17.5	0		Council taxes 1.75 %
6	Cape Verde	15	6		
7	Central African Rep	18			
8	Chad	18	0		
9	Congo Republic	18	0		
10	Egypt	10	5	15; 20; 30	
11	Equatorial Guinea	15	0; 6		
12	Ethiopia	15	0		
13	Gabon	18	0; 10		
14	Ghana	12.5	0		National Health Levy 2.5%
15	Guinea	18			
16	Guinea-Bissau	15			
17	Ivory Coast	18	0		
18	Kenya	16	0		
19	Lesotho	14	0; 5	15	
20	Madagascar	18	0		Transaction tax – non-vendors 5%
21	Malawi	17.5	0		
22	Mali	18			
23	Mauritania	14	0		
24	Mauritius	15	0		
25	Morocco	20	7; 10; 14		
26	Mozambique	17	0		Simplified VAT 5%
27	Namibia	15	0		
28	Niger	19			
29	Nigeria	5			
30	Rwanda	18	0		
31	Senegal	18			
32	Seychelles	12; 15	0; 7; 10		
33	South Africa	14	0		
34	Sudan	10	0		
35	Tanzania	20	0		
36	Togo	18			
37	Tunisia	18	6; 12		
38	Uganda	18	0		
39	Zambia	17.5	0		
40	Zimbabwe	15	0	22.5	

Data valid at date of publication

The proportion of VAT as a percentage of total taxes in South Africa, at just above 27 per cent, represents a relatively stable contribution of VAT to overall budget, as detailed in the table below.

Barriers to doing business and the need for reform

Businesses should not experience double taxation and VAT should not raise any barriers to doing business in South Africa. Though in theory the same certainty should apply across Africa, on a practical level businesses may experience some problems with the administration of refund claims for input VAT. Clearly in the start-up phase of a business this can be a significant barrier to investment and is an area that requires attention to ensure that businesses are not deterred from investing.

More generally, while legislation is often relatively straightforward there are quite often practical and administrative requirements that can become quite onerous. While the principles are clear from a VAT perspective, it can take more time than necessary to register a business and the process is not as simple as it could be. This is particularly the case for smaller businesses and as a consequence, there is much discussion in South Africa of the need to make tax administration and compliance less complex and burdensome for the entrepreneurial SME sector.

A further issue that is being addressed in South Africa is the absence of rules relating to place of supply.

This has a significant impact on telecommunications, online sales and purchases. It also creates a problem for foreign businesses in terms of deciding when they need to register and in particular for global groups with personnel on secondment in South Africa. Progress is being made to address this and South Africa is involved for the first time in an OECD sub-committee looking into place of supply rules.

There is also progress being made to clarify the VAT provisions covering the streamlining of business organisations. A lack of provisions to date has meant that businesses have experienced a significant degree of uncertainty over the VAT implications arising from the rationalisation of corporate and business structures.

Finally, legislation is required to address ambiguities relating to developments in financial services. There are substantial exemptions from VAT for many financial services and products but considerable uncertainty persists in relation to certain 'modern financial practices' e.g. derivative instruments. The fast-moving nature of the industry means that VAT legislation is often left trailing in the wake of rapid financial innovation.

Compliance, technology and anti-avoidance

South Africa generally has created considerable uncertainty and has a high degree of voluntary compliance, and the tax authorities are increasingly efficient and sophisticated in their approach to audit.

	2005 / 2006 (Outcome) (ZAR million)	2006 / 2007 (Revised estimate) (ZAR million)	2007 / 2008 (Budget estimate) (ZAR million)
Personal income tax	125,645	139,000	163,900
Company tax	86,161	114,771	139,300
VAT	114,352	134,562	155,068
Other taxes	91,176	101,329	110,694
Total	417,334	489,662	568,962
VAT as percentage of total	27.4%	27.48%	27.25%

Source: "Budget Review 2007" issued by National Treasury of the Republic of South Africa, 21 February 2007, pages 64 & 67

The removal of binding rulings has created considerable uncertainty and has led to the situation whereby businesses that are subject to audit are no longer able to rely on the certainty created by prior rulings. This factor coupled with a more aggressive approach to audits means that there is likely to be an upsurge in litigation arising from disputed VAT issues. However, a number of factors including the high costs and significant amounts of time associated with legal actions in South Africa, as well as concerns over confidentiality, mean that cases are often settled without full argument in court. This has a detrimental impact on the quantity and quality of precedent available and means that principles are not established through detailed argumentation in open court. This in turn creates a drag on the development of the tax system more generally. The introduction of provisions empowering the revenue authorities to settle disputes in particular circumstances has also led to an overemphasis on out-of-court settlements.

The use of technology for the VAT compliance is relatively advanced in South Africa. However, the degree of sophistication in the analysis created by the system that accompanied the introduction of VAT in 1991 has not been seen to be as successful as initially hoped. In recent years there has been much greater use of data mining techniques, though the sheer volume of available information generated by IT systems continues to raise challenges for both tax authorities and taxpayers alike.

Tax avoidance provisions have been in place since the beginning of the VAT system in South Africa although there has been little in terms of testing the application of these provisions by taxpayers. The income tax arena has seen recent development on anti-avoidance measures and it is highly likely that these will also influence the approach taken towards indirect taxation.

Asia Pacific

What are the main relevant indirect taxes?

The overwhelming majority of countries in the Asia Pacific region now operate a VAT or GST system in one form or another. The first country to introduce a VAT system in the region was South Korea in 1976, and this was followed nine years later by Indonesia and Taiwan introducing the tax. Over the last twenty years, VAT or GST has been a major feature of tax reform for nearly all countries in the region.

The table below indicates the dates when VAT was introduced in different countries across Asia Pacific along with the corresponding rates.

Country	Introduced	Standard rate*	OECD Member
South Korea	1976	10%	√ - 1996
Indonesia	1985	10%	
Taiwan	1985	5%	
New Zealand	1986	12.5%	√ - 1973
Philippines	1988	12%	
Japan	1989	5%	√ - 1964
Pakistan	1990	15%	
Bangladesh	1991	15%	
Thailand	1992	7%	
China	1994	17%	
Singapore	1994	5%**	
Cambodia	1999	10%	
Vietnam	1999	10%	
Australia	2000	10%	√ - 1971
India	2005	12.5%	
Hong Kong	?	?	
Malaysia	?	?	
Laos	?	?	

Source: PricewaterhouseCoopers



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* Current

** W.e.f 1 July 07 will be 7%

In implementing a VAT or GST system, most of these follow a model largely based on the EU system and have the familiar 'look and feel' of the EU VAT model. However, the precise nature of the way in which some of the systems are structured and the manner in which the tax authorities administer the law means that there is some variation in the way that the taxes are operated. So while there are systems that would be familiar to taxpayers in the EU, others are less so. There is a lack of convergence in the region's different indirect tax systems as governments are driven by different revenue objectives.

Significant recent developments

Two countries in the region that have been considering the introduction of a GST system but have not yet done so are Malaysia and Hong Kong. Malaysia had planned to implement a VAT/GST system from the 1st January 2007 to replace the current sales and service tax system that applies to a limited range of goods and services. A discussion paper was released in July 2005, but in early 2006 the Malaysian government decided to put the proposed system on hold, basing their decision on the need to provide businesses with more time to prepare their systems. While GST implementation has been put on hold for an undetermined period, it is understood that the Malaysian customs authority is continuing its work on fine-tuning the development of the legislation as well as drawing up guidelines that will apply to specific industries. There is however no indication of firm implementation dates, though a second discussion paper is widely expected to be published in 2007.

Hong Kong also recently drew up plans to introduce GST. A nine-month consultation process was launched in July of 2006. However, there was a significant degree of popular objection to the proposed measures. In response, the Hong Kong government announced that while consultation on indirect taxes would proceed, this would no longer include the proposal for the GST. It therefore seems unlikely that GST – in any form – will be implemented in the near future in Hong Kong.

The majority of governments in the region that impose VAT or GST do so at comparatively low rates, on average at a rate far below the norm in the European Union. Apart from China, which has a 17 per cent rate of VAT, the rates range from 5 per cent (Japan, Taiwan and Singapore) to 12.5 per cent (India and New Zealand).

However, in Singapore the rate of GST will rise from 5 to 7 per cent with effect from 1 July 2007. The Singapore government said that it needed the GST increase in order to be able to fund its social programmes for the future. The last increase was in 2004 (from 4 to 5 per cent) and the latest was not expected so soon after. As a consequence, the corporate income tax rate in Singapore is to be reduced from 20 to 18 per cent to attract new foreign investments.

On a broader regional level, no governments have expressed their intention to introduce environmental taxes in any form (although this is one of the alternative taxes considered in the consultation on indirect taxes in Hong Kong). Rather than imposing a tax on consumption that is seen as environmentally damaging, governments in the region are far more likely to encourage more environmentally sustainable behaviour and technology through the use of incentives.

Is there a shift from direct to indirect taxes?

There are clear indications that many of the countries in the region are moving in a direction that is consistent with the global trend of deriving a higher proportion of their revenues from indirect taxes. In Singapore, for example, GST is wholly consistent with global trends in that direction. When Singapore first introduced GST in 1994, the tax was responsible for approximately 11 per cent of government tax revenue. In the last financial year that proportion had nearly doubled to around 20 per cent. It is true to say that Asia Pacific economies are seeing the shift to lower direct taxes and a higher burden in terms of indirect taxes. As further evidence of this, Malaysia is expected to reduce direct tax in preparation for the introduction of GST.

Barriers to doing business and the need for reform

In common with the situation in other parts of the world, the application of VAT/GST rules to financial services businesses is in need of reform, in particular with regard to exempt supplies. Financial services businesses bear an additional cost on their operations that places them at an economic disadvantage to their counterparts. Some governments in the region have taken some measures to address this. New Zealand, for example, allows zero rating for particular business-to-business financial services under certain conditions and Singapore offers partial recovery for GST imposed on financial services. Interestingly, when the Hong Kong government published its consultative document for GST, it proposed a zero-rating regime for financial services. Though this will now not proceed, it would have been interesting to see how other governments in the region would have reacted to the creation of a more competitive regime for Hong Kong.

Reform in the region has tended to be in the form of fine-tuning rather than any major overhaul of indirect tax systems. In terms of greater cooperation and integration between countries in the region, any notion of convergence of indirect tax systems seems very distant in terms of VAT/GST. There is more discussion of moving to create a Free Trade Agreement for Asia Pacific that would necessarily entail greater economic convergence and further action to remove barriers to trade such as tariffs and duties. However, GST systems are still seen as very local and driven by the needs of each individual government. Although, drawing on the EU model, GST would be one of the taxes that would appear to be a logical fit with greater regional integration, the tax has never been mentioned alongside tariffs and duties in discussions about the steps required to liberalise trade further in the region.

Compliance, technology and anti-avoidance

The degree of voluntary compliance inevitably varies across the region but is generally seen as high. Tax authorities in the region are making greater use of

technology in the assessment and administration of GST. One of the regional pioneers, New Zealand introduced electronic filing and payment from 2002 and in Singapore there is now a move to make electronic filing compulsory. Taxpayers in Thailand have from 2000 been able to file their VAT returns online. Along with the general trend towards automating the compliance process, revenue authorities are using technology tools to conduct audits and are making extensive use of online communication channels for the dissemination of general information to taxpayers and the public.

Businesses are also using similar tools to assess and manage their own GST as well as for the administration and management of their tax risks. However, some of the mistakes appearing in returns arise from simple transposition errors, suggesting that some companies have some progress to make in fully automating their processes.

The revenue authorities are unquestionably becoming more aggressive in their approach and there is concern about aggressive tax audits and higher penalties across the region.

Despite a more aggressive approach, litigation in the region tends not to focus on how the law is applied and interpreted by the revenue authorities, but is more likely to be focused on challenging the outcome from a specific audit. Most other cases are in terms of contractual issues, concentrating on collection and recovery rather than points of principle.

Australia

What are the main relevant indirect taxes?

Introduced on 1 July 2000, Goods and Services Tax (GST) is now the major indirect tax in Australia. Prior to its implementation, the tax was the subject of considerable political debate, and became the most significant issue debated in the 1998 election campaign.

The Australian system is a broad-based GST, applied at a rate of 10 per cent, and administered by the Australian Tax Office (ATO). Exemptions to the tax are fairly limited and apply to exports, medical goods, and certain basic foodstuffs. Exemptions relating to inputs relate primarily to financial services and to residential property.

Other indirect taxes in Australia include customs duties – the rates for which are typically fairly low at between 3 and 5 per cent – and a range of indirect taxes such as stamp duties and payroll taxes that are administered individually by each of the six states and two territories.

Australia has not to date introduced any significant taxes specifically aimed at achieving environmental policy goals (such as reducing carbon emissions) and there is an ongoing debate about whether some form of carbon trading scheme, or carbon taxes, would be the preferable route to follow. The signs to date are that there does not seem to be a significant appetite for carbon taxes over other measures.

Significant recent developments

Over the last two or three years there has been a significant increase in auditing activity by the ATO. This is indicative of a hardening of attitude that has resulted in the application of more penalties and a generally less tolerant regime. Previously, owing to the tax's relative youth, there had been a tendency to treat taxpayers' errors and mistakes with a degree of indulgence and a willingness to see them as part of the education process for taxpayers. That phase is now avowedly complete, and businesses can expect a stricter and more punitive approach to errors. Put bluntly, businesses are now simply expected to get things right the first time.



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Is there a shift from direct to indirect taxation?

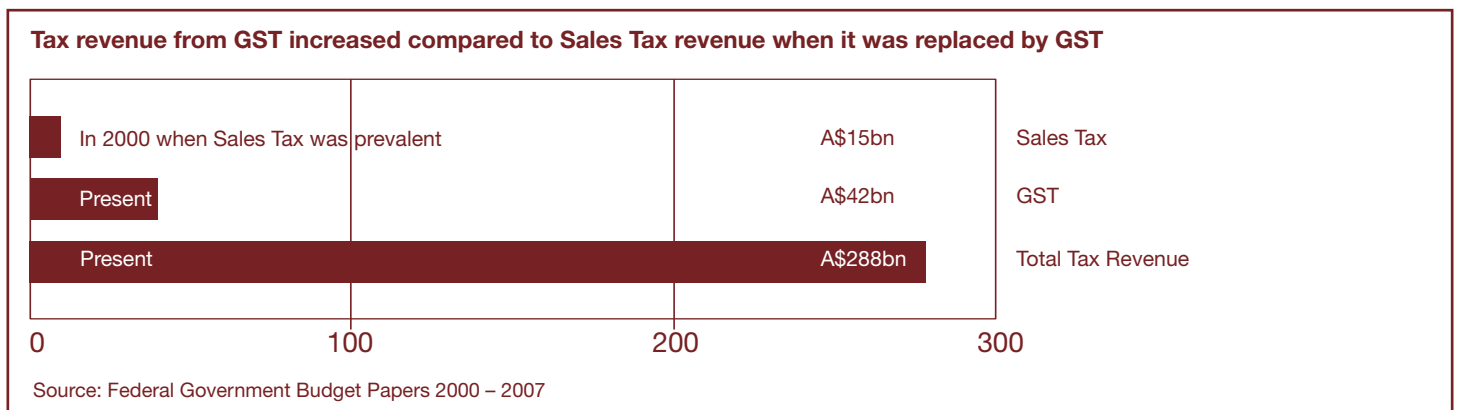
The introduction of GST represented a significant shift from direct to indirect taxes as a proportion of the nation’s federal tax revenues. Accordingly, the tax’s introduction was accompanied by a lowering of income tax rates. This has meant that from a budget of approximately A\$288bn, some A\$42bn of tax revenue now comes from GST, compared to the A\$15bn or so that was contributed by the sales tax that GST has replaced (see table below). It is unlikely that additional indirect taxes will be introduced in the foreseeable future.

Barriers to doing business and the need for reform

The introduction of GST has removed the burden on exporters imposed by the sales tax. The cost of that tax was embedded in the price of exported goods and services, creating a significant burden on the ability of Australian exporters to compete internationally. GST’s effective removal of that last remaining significant barrier has greatly assisted Australian exporters. In general terms, for both national and international firms investing and doing business in Australia, the GST regime is a simpler and more business-friendly regime. But indirect tax complications remain at the local level that arguably place an unnecessarily high burden of compliance on businesses.

The six states and two territories each operate separate payroll and stamp duties which vary from jurisdiction to jurisdiction in their base and rates. Businesses operating across Australia therefore have to address the administration of GST on a national basis as well as payroll taxes that vary from state to state and similarly variable stamp duties. The cost and time of administering this compliance burden arguably means that there is a strong case for the abolition of the separate payroll taxes in Australia and balancing the lost revenue by proportionately increasing the rate of GST. Replacing payroll tax (which as a partial GST represents an inefficient, distorting and complex tax that creates an additional burden of administration) at the state and territory level with one tax that provides the same revenue outcome but without the detrimental costs of administration would appear to make a very good case for reform.

Indeed, when Australia first debated the introduction of GST in the early 1990s this was part of the proposal but was not carried forward. When several years later GST came back on to the political agenda it reappeared at a lower rate and without the abolition of payroll tax as part of its introduction. Though businesses would be broadly well-disposed to the change, there are likely to be some winners and losers arising from the abolition of payroll tax (depending on the number of employees in a business) and there is little appetite at present



for further debate. The depth of the change that GST introduced to the indirect tax system means that the appetite for further reform in Australia is likely to remain limited for the foreseeable future.

Compliance, technology and anti-avoidance

There is a high level of voluntary compliance with GST and other indirect taxes in Australia. Securing and reinforcing that 'compliance culture' is the ATO's principal strategy. To that end, the ATO strongly encourages and provides considerable education and resources to help taxpayers to comply. In addition, the penalty regime is designed and driven around the promotion of voluntary compliance and by and large there is also a genuine will among the Australian tax paying community to comply.

By virtue of the GST system's very recent introduction the ATO was able simultaneously to implement a sophisticated IT system to carry out audits and assessments of even the largest corporate filers. Even prior to the launch of GST, the ATO was acknowledged as one of the most advanced revenue authorities in the world in its use of technology. So it was a natural step for the ATO to use advanced technology and software tools to conduct its analysis of businesses and use IT extensively in its audit procedures. The ATO routinely uses system-based tools that can interrogate and analyse substantial quantities of data from tax payers, and of course tax payers are able to file and pay taxes in an entirely online environment. Businesses also use similar tools to manage their own tax risks and administration.

Litigation relating to indirect tax represents a rapidly-growing proportion of all tax litigation. A recent report indicated that indirect tax litigation will shortly account for one-third of all tax litigation in Australia, an estimate with which the ATO is in broad agreement.

Given the more aggressive stance adopted by the ATO towards errors and omissions and the related increase in audit activity, we are now starting to see the signs of an emerging GST jurisprudence in Australia. There is an

exponential increase in case law coming through the courts which is indicating that Australian GST law must be treated on its own terms rather than with reference to other GST/VAT systems. Businesses familiar with the European system have perhaps tended to transpose their understanding of its operation to the Australian system. They will increasingly find that this approach is fraught with difficulty.

The youth of the Australian GST system means that there is inevitably a considerable lack of certainty in relation to both the principles and detailed application of the law. In order to help address that uncertainty, the ATO is operating a test-case funding programme. Where there are matters of principle in law at stake, it is possible for taxpayers to apply to the tax office in order to receive funding for a case so that a ruling can be achieved and precedent established. This enlightened approach by the ATO is allowing some issues to be tested that would otherwise not be, and is accelerating the development of useful case law.

There has been little in the way of GST avoidance. The legislation contains an all-encompassing general anti-avoidance provision (GAAP) – probably the broadest GAAP in legislation in application anywhere in the world. Its scope is so broad it catches any scheme or transaction that has the result of or the effect of reducing the amount of GST payable. And for that purpose the legislation can, through an extraordinary provision, deem things that have not occurred to have occurred, and things that have happened to have not happened. Though in other tax contexts the courts have interpreted this very broadly it is yet to be tested in the GST arena. To date there has been only one minor tribunal decision addressed on GST avoidance.

Canada

What are the main relevant indirect taxes?

Canada operates a federal levy, the Goods and Services Tax (GST), that was introduced in 1991. This is a VAT which operates on a very similar basis to other VAT systems such as the EU model. There are however additional levies in the form of sales taxes and other types of VAT which operate at the provincial level and vary quite considerably across the ten Canadian provinces, as detailed in the table below:

Canadian Federal Goods and Services Tax ("GST") and Provincial Sales Tax Rates

Provinces	Provincial Sales Tax	Federal GST[2]	Combined Total[1]
British Columbia	7%	6%	13%
Alberta	0%	6%	6%
Saskatchewan	5%	6%	11%
Manitoba	7%	6%	13%
Ontario	8%	6%	14%
Quebec	7.5%[2]	6%	13.95%
Nova Scotia	14% HST[2] (Harmonised Sales Tax)		14%
New Brunswick	14% HST[2] (Harmonised Sales Tax)		14%
Newfoundland	14% HST[2] (Harmonised Sales Tax)		14%
Prince Edward Island	10%	6%	16.6%

[1] Quebec and Prince Edward Island provincial sales taxes are calculated on the GST included amount.

[2] Value-added tax



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The lack of harmonisation across the country means that Canada operates with a complex mix of indirect taxes. Whereas one province has no provincial sales tax, five have a provincial sales tax (PST) similar to a US sales and use tax (i.e. a tax that applies to the final consumer of goods and services rather than further up the supply chain). Four of the provinces have also harmonised their provincial sales taxes with the federal GST. While in some provinces there is harmonisation between federal and local indirect taxes, others operate with two systems in parallel. This inevitably creates complexity for some taxpayers. Typically, they may be familiar with a VAT but not a sales and use tax, or as is often the case for US businesses operating cross-border, may be used to dealing with a sales and use tax, but not VAT.

Significant recent developments

As a result of this complexity, a constantly recurring issue is the question of if and when full harmonisation with the GST will ever be achieved across all the provinces. There are some indications that trends are moving in that direction. For example there has been a noticeable broadening of the base, so that more types of supply (i.e. more services) are covered, and this would traditionally be associated with a VAT as opposed to PST-type base. However, these possible trends aside, the outlook for full harmonisation across the provinces remains a subject of speculation rather than a prediction based on concrete evidence from official statements or policy initiatives.

In terms of federal GST, there has been a marked trend for the revenue authorities to maintain a close adherence to the technical purity of the GST rules in cases where that interpretation seems to be at odds with the original intent of the legislation and/or its application in practice. This has been the case particularly in relation to non-residents' GST registration requirements and has led to a degree of uncertainty among non-residents about the circumstances and conditions they should meet in order to register.

In much the same way, a number of cross-border scenarios and issues present taxpayers with a similar problem and the situation is unquestionably becoming more complex in terms of when GST applies and when it does not. Again, interpretation is emerging as a problematic issue, almost to the point where VAT practitioners themselves are unsure about whether they should provide the technically or administratively 'correct' answer.

In addition to these trends, there have also been some new rules with regards to financial institutions as well as a one per cent decrease in the rate of federal GST, with the government suggesting that a further decrease may be applied in the future.

Though there are at present only a limited number of environmental levies that apply in certain jurisdictions, there is a sense that these may increase in number on a provincial basis as governments develop their understanding of environmental concerns and the fiscal levers that can help to address them.

Is there a shift from direct to indirect taxation?

From 1 July 2006, the federal government reduced GST by one per cent. This perhaps indicates that the shift away from direct taxation seen elsewhere in the world may not be happening in the same way in Canada. The GST is not a very popular tax among the Canadian electorate and for Canada's minority government a reduction in the rate of the tax was seen as a shrewd populist move.

Barriers to doing business and the need for reform

There is a developing perception that many of the interpretations and assessments by the revenue authorities are taking an aggressive line and are seeking to catch more non-residents in the GST system.

At the provincial level there are some complexities within the PST rules as they apply to specific types of businesses and these may be seen as creating a disincentive for those businesses to invest. In Ontario,

for example, the rules relating to IT and software businesses are highly complex, to the point that businesses within the sector may consider this to be a factor when making their location investment decisions, particularly when comparing Ontario with other suitable locations. And there are other similar examples across the provinces. Therefore, in addition to handling the complexity of parallel provincial and federal indirect taxes, the details of some of the tax rules relating to particular goods and services could cause businesses in those areas to think hard about the alternative locations open to them.

Given the above, the rules with respect to non-residents in Canada need to be made as simple as possible. Where a non-resident does not have a significant presence in Canada and therefore there is no real issue of tax leakage, streamlining the tax process to make it as simple and accommodating as possible would be an initiative that many would welcome. In much the same way, harmonisation across the provinces could also be seen as a significantly progressive step and would simplify many unnecessarily complex current issues. Arguably, it also makes a great deal of sense to simplify the rules relating to specific industries in order to make each province as hospitable to investment from those businesses as possible. Indeed, some provinces are doing this and there is a clear appetite from Canadian business for a more harmonised and simplified regime.

Compliance, technology and anti-avoidance

In their drive to become more efficient over the last few years, the tax authorities have made greater use of technology and it has become the norm for auditors to download significant amounts of information from taxpayers. In fact, this is now an expectation from the tax authorities and an inability or unwillingness by the taxpayer to oblige may be viewed as cause for concern. There is a strong preference to use e-auditing and other data mining techniques which accomplishes a number of goals from the revenue authorities' point of view being both more efficient and comprehensive in its scope than traditional methods allow. Taxpayers are

also using more IT tools to help mitigate their tax risks and are increasingly aware of tax risks and controls that arise from the use of systems. Companies are also hiring specialists to look for refund opportunities using data mining techniques.

There is a generally more aggressive approach from the revenue authorities, evident at both the provincial and federal level. Both have certainly hired more auditors, but more broadly there is a generally harder and inflexible line being taken towards assessments and interpretations.

Levels of voluntary compliance are high, and tax evasion and fraud are pursued aggressively and severely punished by the revenue authorities. Legitimate planning that seeks to take advantage of any gaps in the legislation is a source of some tension, and the federal authorities have repeatedly addressed such opportunities with retroactive legislation. In general where creative interpretations of the legislation have been successfully applied there would be an expectation that the legislation would be suitably adjusted on a forward-looking basis rather than retroactively. As a result, taxpayers tend to be very cautious about tax planning.

There is a significant amount of litigation relating to GST issues and there is a growing body of precedent that is helping to create greater certainty in the regime governing what is in effect a relatively youthful system. Issues can also be pursued through an 'informal procedure' which provides a less costly (there is no strict requirement to be represented by a lawyer), swifter route to achieving a ruling outside of the full court hearing. Although the decisions of informal procedures do not give rise to precedents, the tax courts nonetheless refer to their rulings.

There is less litigation in relation to PST issues and there is seen to be less appetite on the part of the provincial authorities to litigate. Where cases are brought, they often tend to be settled 'on the courtroom steps'.

Central and Eastern Europe

What are the main relevant indirect taxes?

The indirect tax systems across Central and Eastern Europe are increasingly coming to resemble the regime in the European Union. This convergence with the EU is taking place not only in the countries that have joined the EU, including the most recent accession countries of Romania and Bulgaria, but also in other countries in the region that have yet to join.

As part of this shift, most countries in Central and Eastern Europe have either introduced indirect tax systems directly based on the European Union regime – founded on the 6th VAT Directive, the Community Customs Code and the EU Excise Tax concept – or have systems that are similar to the EU's in many respects. All the EU members in the region are now largely aligned with the rest of the EU, and Russia, the CIS and Balkan states are essentially following the same route.

A further reason for most non-EU member countries to move towards the EU model is to strengthen their applications for EU membership. However, Russia is a slightly different case. While it is clearly unlikely that Russia will become an EU member in the foreseeable future, much of its trade is with EU countries or countries with EU-style indirect tax regimes, making EU legislation a suitable guideline for Russia's approach to VAT, Excise and Customs.

Significant recent developments

Not surprisingly, recent developments have been dominated by the trend towards the EU model. The accession of Bulgaria and Romania on 1 January 2007 saw them strengthen their indirect tax systems in line with the EU. This in turn encouraged the neighbouring countries in the former Yugoslavia to move in the same direction – something they are happy to do, given their long-term aspirations to EU membership, and the fact that an appropriate indirect tax system is a precondition for entry.

The wider adoption of the EU system is being accompanied by growing familiarity with and understanding of the EU regime among governments and tax and customs authorities. In practice, the application of EU legislation is gradually becoming more accurate, and increasingly aligned with that in long-standing EU member countries. At the same time, most



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national parliaments across the region are working on the preparation of new, more EU-aligned VAT and/or customs legislation. Examples include recent or new member states such as Poland, the Czech Republic, Romania and Bulgaria

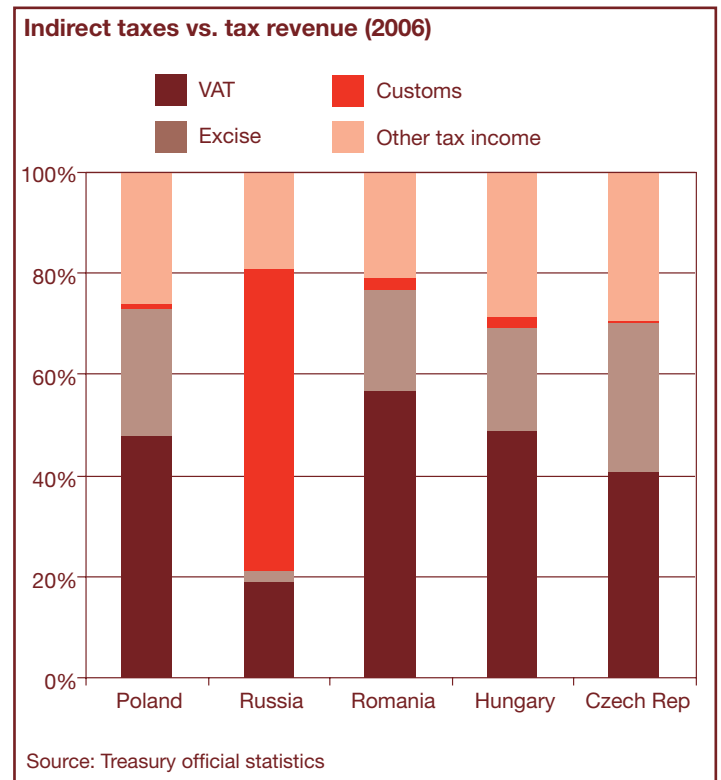
Is there a shift from direct to indirect taxes?

A highly visible shift is currently under way – at least in the new accession countries – from direct to indirect taxation, which is playing a more and more important role in the budget revenues of countries in the region. In general, about 60 per cent of government income comes from indirect taxes as detailed in the table opposite. In countries such as Poland, the Czech Republic and Hungary this proportion is rising still higher. Rather than being the direct result of tax policy, this shift towards indirect taxation is primarily driven by economic factors, reflecting the adoption of a market-based system and ongoing growth in the regional economy.

Barriers to doing business and the need for reform

As we mentioned above, national tax and customs authorities in Central and Eastern Europe are on a steep learning curve. This is one of the drivers behind the ongoing amendments to indirect tax systems, with the majority of countries in the region now in the process of developing new VAT and/or excise tax laws. This rapid and widespread change also underlines the fact that substantial discrepancies still exist in the practical application and interpretation of the EU indirect tax system – with many national systems in Central and Eastern Europe currently hampered by poor knowledge of practicalities, low standards of legal expertise within tax and customs authorities, and a tendency for the authorities to automatically feel suspicious about companies' behaviour, tending to treat them as potential thieves rather than business partners.

The tax and customs authorities themselves appreciate the problems, and understand the need for change in the way they approach, manage and control the market.



However, in many countries the pressure for reform is also being driven by the businesses themselves, which are pressing for the VAT and Excise system to be simplified and streamlined in ways that would benefit the whole economy. Experience shows that an efficient indirect taxation system that is easy for businesses to use will usually reap higher revenues. The fact that the accession countries tended to join the EU with a basic VAT law in place, lacking the fine-tuning now seen in national regimes in Western Europe, means there is often substantial scope for improvement and simplification.

The main barrier to reform tends to lie on the part of the tax and customs authorities, which are insufficiently educated about the EU-style systems that have been introduced in recent years. For many years, the authorities were accustomed to applying indirect tax

regimes that resembled the EU model, but without the influence of cases in the European Court of Justice (ECJ). The need for the authorities to get up-to-speed in the new system is creating a lot of problems, not least because businesses and their advisers often understand it better than the authorities themselves. As the authorities move up the learning-curve, this will benefit the whole system and all its participants.

Compliance, technology and anti-avoidance

The fact that indirect taxes usually account for the majority of state revenues means the tax and customs authorities are especially keen to boost compliance, since this should have a more beneficial impact on revenues. The focus on strengthening control and compliance in indirect tax – especially around VAT – is a highly visible trend in countries such as Poland, the Czech Republic, Bulgaria, Hungary and Romania. These efforts also reflect the fact that the biggest potential for frauds and non-compliance, and indeed the majority of tax frauds that actually occur, tend to be in the indirect tax area.

With this in mind, the tax and customs authorities are making growing use of sophisticated IT systems to track and control companies' behaviour. For example, the tax authorities in Poland recently bought 200 licences for ACL, a Canadian-developed software system designed to enable rapid analysis of large amounts of data. The ability to store and analyse data in electronic form can enable the authorities to be much more efficient than using traditional manual working methods based on paper documents. Instead of being able to examine three to five files a week, an investigator can review three years' worth of documents at the click of a mouse.

The efforts to increase compliance, including the use of new technology, are manifesting themselves in a sharp rise in the number of litigation cases focused on alleged non-compliance with indirect tax regulations, mainly VAT and Excise. This increase is being seen across the region and in Russia. Most cases go through the entire administration and appeals procedure and eventually

end up in court, meaning they take a long time and consume large amounts of money. The courts, which tend to be more business-orientated than the tax and customs authorities, generally apply EU legislation and relevant ECJ cases – and usually find in favour of the defendant company. This reflects the tax and customs authorities' relatively poor knowledge of the system, and their frequent failure to find and produce sufficient evidence to win the case.

In terms of voluntary compliance, the culture tends to differ between larger and smaller businesses. For the larger companies compliance is natural, but this is not necessarily the case among smaller businesses, where attempts at avoidance are not unusual. And in cases where smaller companies are looking to avoid payment, indirect tax – particularly VAT – often presents the most obvious opportunities. In Poland, for example, VAT avoidance represents the single biggest worry for the tax authorities.

It is difficult to establish firm figures for the costs of indirect tax compliance across Central and Eastern Europe, but it seems likely that it is somewhat higher than in Western Europe. This results from a range of factors, including imperfect and rapidly-changing legislation, the aggressive approach taken by the tax authorities, and the relatively low level of understanding of the system. Also, lower-cost tools such as e-invoicing – commonly used in Western Europe – are less widely deployed so far in Central and Eastern Europe, partly because of suspicion on the part of the tax and customs authorities.

China

What are the main relevant indirect taxes?

On 1 January 1994, China introduced a turnover tax system consisting of three taxes: VAT, Business Tax and Consumption Tax.

VAT applies to the sale or importation of goods and the provision of repairs, replacement, and processing services. Non VAT-able services provided in China and the transfer of real property and intangible assets are subject to Business Tax. Consumption Tax is imposed on specific categories of goods, including cigarettes, alcoholic beverages, and certain luxury items.

Significant recent developments

While still a relatively young tax system, the dynamic nature of the Chinese economy means that the indirect tax regime has already been subject to considerable change in order to be able to reflect developments in economic behaviour in China and the growing prosperity of its population.

The change to export VAT refunds introduced in 2006 demonstrates a trend away from encouraging all export activity towards the creation of a tax regime that favours specific sectors, particularly the high-tech industries over others.

The new provisions mean that certain types of exporters will no longer be able to recover input VAT incurred on processing and export activities, while others are seeing reduced export VAT refund rates apply to particular types of export.

There have been controversial changes to the Business Tax exemption on interest and rental income from leasing of movable properties derived by foreign investors. Although the details and implementation of the changes are still subject to clarification, Business Tax may become an additional tax cost for lenders and lessors.

Consumption taxes have also been developed to take account of changing categories of consumption in China and to create an additional tax burden on the consumption and use of certain products that are seen as having a direct and negative impact on environmental quality. The list of items now



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subject to consumption tax includes luxury watches and yachts at one end, and disposable wooden chopsticks and wooden floors at the other.

Environmental influences have already been seen in some of the changes to consumption tax, and it is highly probable that the Chinese government will seek further measures to modify behaviour and patterns of consumption that are seen as environmentally damaging.

Is there a shift from direct to indirect taxation?

Indirect taxes already account for a significant proportion of tax revenue in China. Data from the 2005 China Statistical Year Book, edited by the PRC National Bureau of Statistics, shows that indirect taxes contributed two-thirds of the entire tax revenue. VAT accounts for half of this total, with Business Tax contributing 14 per cent of national tax revenue.

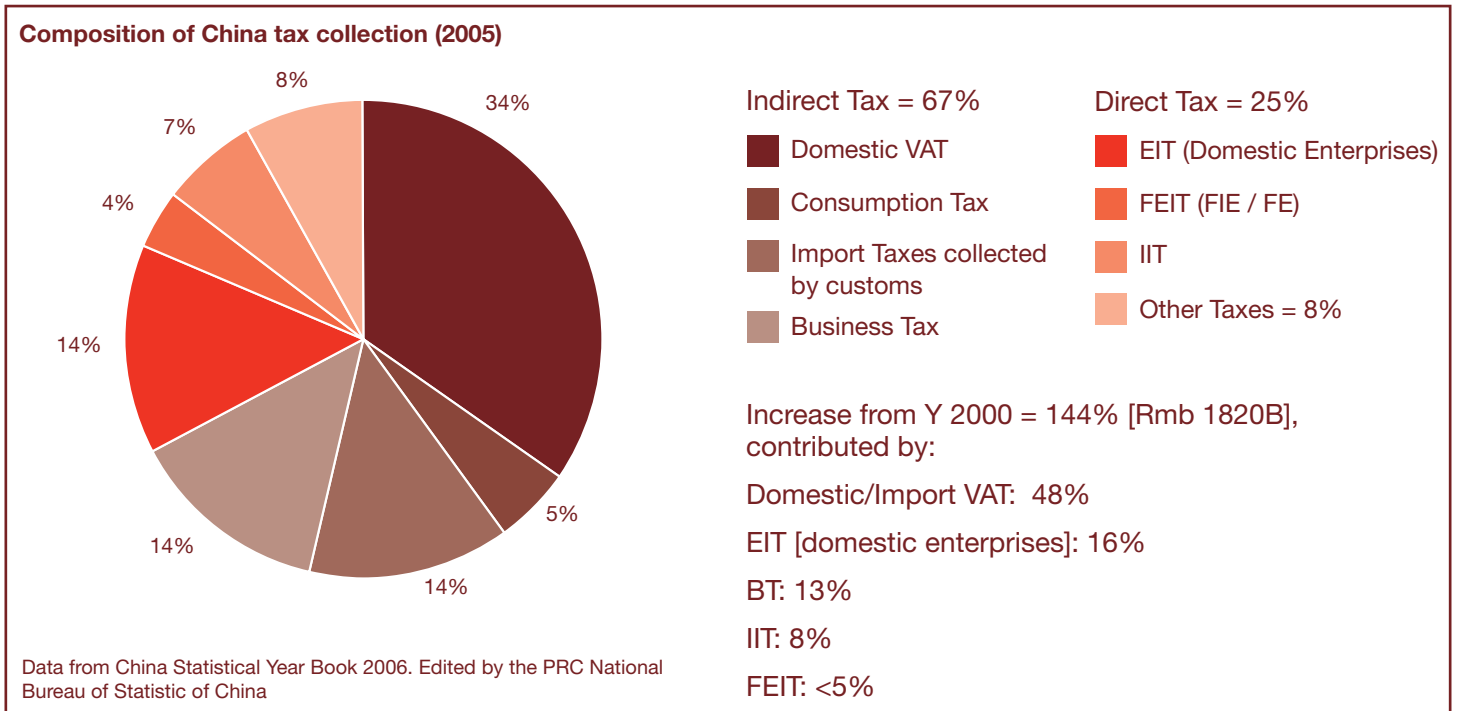
Consumption tax provides five per cent of that national total. This is shown in the charts below:

The very recent changes announced to the corporate income tax system may shift the tax revenue collection profile even further onto the indirect system as it is anticipated that the corporate tax reforms will create a significant reduction in the direct tax revenue.

Barriers to trade and the need for reform

The volume and rapid growth of trade with and within China suggests that even if there are any perceived barriers presented by aspects of the indirect tax system, they create little in the way of a threat to the development of business between China and the rest of the world.

The current focus of tax reform in China is direct taxation – corporate income tax in particular. However,



Indirect taxes vs PRC tax revenue generated (2001 to 2005)

	USD 1 Trillion					% of tax revenue (2005)
	2001	2002	2003	2004	2005	
Total Tax Revenue	190.8	213.8	257.4	323.5	388.2	
Value Added Tax (VAT)	68.6	78.9	92.3	112.3	134.6	34.7
Business Tax	26.2	31.0	36.1	45.1	53.2	13.7
Consumption Tax	11.7	13.2	14.9	18.9	20.6	5.3
Import VAT & Consumption Tax	20.8	23.8	35.1	46.6	53.1	13.7
Total indirect taxes	127.3	146.9	178.5	222.9	261.4	67.3

Data from China Statistical Year Book 2006. Edited by the PRC National Bureau of Statistic of China

future items on the reform agenda are likely to include the geographical expansion of consumption-based VAT (currently applied only in certain industrial sectors in North Eastern provinces) and the combination of the VAT regime and Business Tax.

Compliance, technology and anti-avoidance

Though technology is being used to increase the efficiency of indirect tax compliance, there are as yet few instances of tax audits being conducted by electronic means. However, there is discussion about the use of technology to conduct tax audits, and it is likely that there will be greater use by the tax authorities in the near future.

In 1994, China started the Golden Tax project which aims to use a nationwide computer network to match VAT input tax claims against corresponding output.

After completion of the Golden Tax project, taxpayers and tax officials are able to verify the VAT invoices received via their own “anti-fraud invoicing control machines” (Terminal Port of the Golden Tax System) while the tax authorities can monitor all the VAT invoices issued by general VAT payers in China.

In general, voluntary compliance with the indirect tax regime in China is at a high level. Taxpayers have to

use VAT invoices that are issued by – and can only be obtained from – the tax authorities. Strict deadlines attach to their verification by the tax authorities. In this way, taxpayers have to play an active role in the indirect tax compliance process.

Where tax disputes arise, it is highly unusual for taxpayers to resort to litigation as a means of dispute resolution. Instead, negotiation and discussion are the preferred routes to address indirect tax disputes or uncertainties. These discussions are often protracted and may require interactions between different levels of the tax authorities. Occasionally, an uncertainty raised by a taxpayer will be resolved by the issue of a circular by the tax authorities.

Over the years, the Chinese tax authorities have taken measures to combat indirect tax fraud and tax evasion and one of these has been through undertaking VAT audits.

In particular “case-specific” VAT audits have been undertaken to investigate serious offences such as organised VAT fraud. Cases subject to “case specific” VAT audits may come from reports made to the tax authorities or referral from other law enforcement agents.

The European Union

What are the main relevant indirect taxes?

Throughout the EU, VAT is the principle form of indirect taxation and its operations are well known in all 27 member states that presently operate with the tax. The EU VAT Directive (successor of the 6th Directive) governs VAT in all the member states, although some exemptions and discretionary issues remain in the control of individual member states. Standard rates vary from the lowest permissible of 15 per cent (Cyprus and Luxembourg) to the highest of 25 per cent (Sweden and Denmark), though a number of member states apply a reduced rate to particular goods and services. The registration requirements for VAT (in terms of sales turnover required) also vary from member state to member state.

No other taxes are imposed directly on trade in goods and services within the EU and member states apply their own consumption levies on certain products (such as tobacco and alcohol) as well as vehicle and fuel duties.

Environmental levies are likely to become an increasingly prominent form of indirect taxation within the EU, aimed at curbing behaviour and consumption that is seen as contributing to carbon emissions and climate change. Countries such as the Netherlands and the Nordic countries have already introduced measures that address specific consumption, including energy use, water and packaging. Others are expected to follow as further connections are made between economic activity and its damaging effects on the world's climate.

Significant recent developments

The main development that is having an impact across the EU is the so-called missing trader, or 'carousel', fraud. This is becoming a major issue for the EU, significantly eroding the tax base and at a cost which some estimates have placed as high as €100 billion each year. In the last year fraud generally within the EU has emerged as a major concern. In response to this concern, a working party has been established to address the issue of fraud. The group published a working paper in March 2007 that pointed to significant gaps between the actual national



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revenue of some countries and the revenue that might be expected. In some member states this gap may be as wide as 10 per cent. The principal problem in the VAT domain is carousel fraud, and there is now a considerable will to find the best means to combat it. The 'reverse charge' mechanism has been proposed for certain goods and services, though there is as yet no unanimity among member states about whether a reverse charge will be the best solution. The working party is considering whether the reverse charge can be applied to all domestic supplies in one country and for all business-to-business supplies. Four considerations need to be addressed by any solution:

- Any new system would have to provide for a clear reduction of present fraud opportunities and exclude any major new opportunities.
- A proposal must ensure that its imposition does not create any disproportionate administrative burden for businesses.
- There must be no new fraud exposure for member states that wish to maintain the traditional rules.
- Ensure neutral and non-discriminatory treatment for national and other EU operators.

A reverse charge provision is being applied by individual member states in some circumstances (i.e. the UK) but there is likely to be considerable discussion before a comprehensive measure is adopted across the EU.

Other developments across the EU include a continued focus on the VAT provisions relating to financial services and the need to bring legislation that is thirty years old into line with current industry practice. The extent to which financial services have changed means that many organisations use an array of third-party suppliers for the provision of many different activities. Outsourcing in this way does confer economic advantages, but for financial services institutions in the context of the EU, those advantages are diminished by the irrecoverable nature of the VAT that financial services providers have to pay. In light of this challenge, there is considerable

activity underway that aims to understand this problem in terms of the economic impact and the likely competitive effects on the EU. PricewaterhouseCoopers was selected by the European Commission, Taxation and Customs Union DG, to perform a study to increase the understanding of the economic effects of the VAT exemption for financial and insurance services. The objectives of the study were to provide evidence of the inefficiency of the current system and to identify options to remove these inefficiencies. In November 2006, the final report was submitted by PricewaterhouseCoopers. It contained various solutions along with a detailed evaluation of the viability of each, as well as recommendations as to priorities.

There has also been a proposal put forward to address aspects of place of supply that create a complex administrative burden for many European entrepreneurs who are transacting business across borders, both within and beyond the EU. In the present situation, a service supplier has to charge home-state VAT on an invoice, and VAT can only be reclaimed from the country of origin through an 8th directive procedure. This can take a considerable amount of time (from six months to up to four years in some cases) with obvious impacts on cash flow for businesses. The suggested solution is to extend the reverse charge, so that the supplying entrepreneur sends an invoice without VAT and then the recipient applies the VAT themselves and makes the payment accordingly, making for a much simpler administrative process. However, this measure requires unanimity from all member states, which is likely to protract its passage into law.

Is there a shift from direct to indirect taxes?

There is a clear shift in EU member states to put greater emphasis on to indirect rather than direct taxes. Many member states have reduced the levels of corporate and income taxes and have at the same time increased taxes on consumption that have traditionally been seen as less progressive.

Barriers to doing business and the need for reform

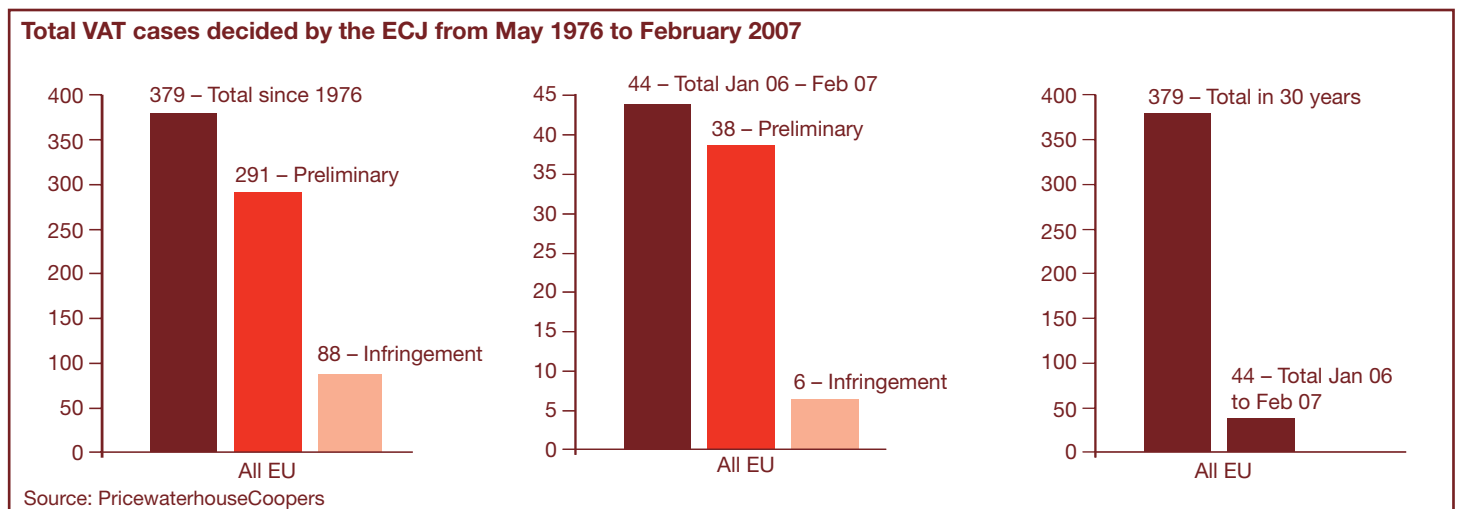
The intention of the VAT system within the EU is – to the greatest extent possible – to provide a harmonised system of indirect taxation that should present few or no barriers to trade between member states. With the exception of financial institutions as noted above, few businesses are likely to experience major economic disadvantages from the operation of the EU VAT system. However, there are a few remaining areas where reform would create still greater harmonisation. One of these is the provision relating to VAT grouping. Though in several member states it is possible for entities with organisational, financial and economic ties to operate intra-entity transactions on a VAT-free basis within the same country, it is however not obligatory to provide for VAT grouping in all member states. Furthermore, there is no equivalent provision for VAT grouping in a cross-border context. Again, the original context of the EU VAT legislation needs to be brought up to date to reflect the increasingly international character of European businesses and other organisations within the EU that are now more likely than not to operate with related entities across several member states.

Compliance, technology and anti-avoidance

Levels of voluntary compliance are generally high across all EU member states and while there is a considerable amount of concern with regards to deliberately fraudulent activity (as noted above), routine compliance is not widely considered problematic by the tax authorities. Technology is increasingly used for compliance purposes, online filing of returns is common and e-invoicing is now widely acceptable throughout member states. The use of technology to conduct audits is also increasingly common, but the use of ‘random checks’ for the purposes of tax audit remains open to question and is being debated in various member states.

There have been a number of high-profile cases in recent years driven by the uncertainties that persist in the EU VAT system. The lack of complete harmonisation between member states’ VAT systems means that there are opportunities for planning and arbitrage though these are increasingly contested by the tax authorities. Recent decisions by the European Court of Justice (e.g. Halifax in September 2006) have added weight to the tax authorities’ clampdown on avoidance schemes.

The graphs below detail the number of cases decided by the ECJ in relation to VAT.



India

What are the main relevant indirect taxes?

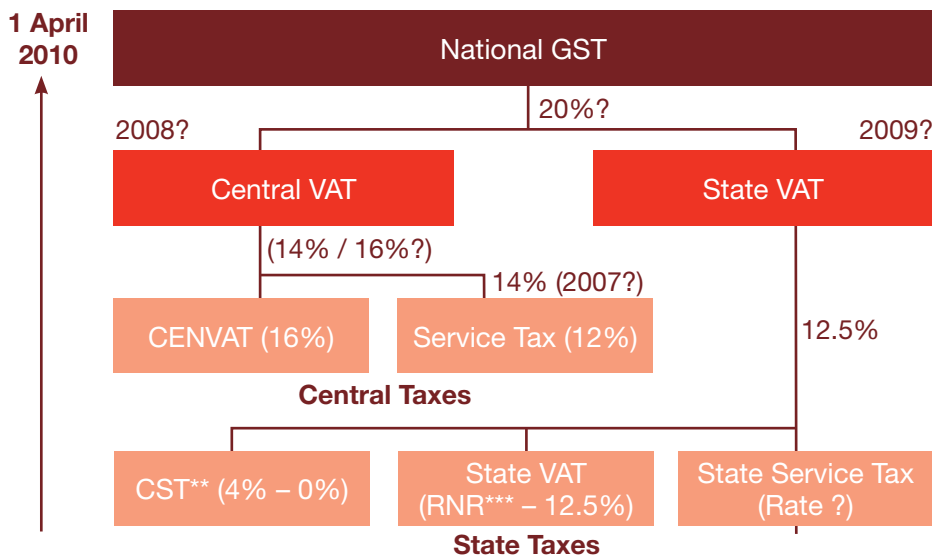
India operates a dual system of VAT, with taxes imposed at both federal and state levels and a further distinction between VAT for goods and VAT for services. The relative complexity of the resulting system has prompted the development of the plan to move to a nationally-unified Goods and Services Tax (GST) that will replace both state and federal VAT and create a simplified and integrated system of indirect taxation by April 2010.

The chart below shows how a probable move towards a national GST may take place in the years to come with indicative years and rate changes.



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Integration of Central and State VAT



*CENVAT: Central Value Added Tax
 **CST: Central Sales Tax
 ***RNR: Revenue Neutral Rate

Source: PricewaterhouseCoopers

Significant recent developments

The development of the unified GST system is the most significant proposed tax change for some time in India. As part of the journey towards achieving a simplified system, a number of integrating steps have already been taken. Further steps would include the equalisation of VAT on goods and services at the federal level.

In the 2007 Budget announcement, the Indian finance minister affirmed the commitment to achieving the unified system by the deadline of 2010 and announced that the Empowered Committee will ensure that the development of GST is on track for implementation by its deadline. The Empowered Committee's first task is likely to be the preparation of a White Paper that will address the roadmap towards the implementation of the GST regime and outline the options in terms of possible routes forward, as a basis for discussion.

Rather than being a new indirect tax, the introduction of GST will be, in effect, an integration and rationalisation of the existing regimes at both federal and state levels. No additional taxes are foreseen in the Indian context.

In the meantime, other developments to the indirect tax system have included the significant extension of the service tax base to cover a wide number of services that were previously exempt from the tax. There are also proposals to change the way that taxes are applied to imports of goods into India. Currently, imports of goods are not subject to tax in the way that imports of services are. In the next 12-18 months the current countervailing duties on imports will be taken out of the customs regime to be replaced with an import VAT for goods.

Although it has announced a number of policy initiatives aimed at addressing climate change, India has not in any meaningful sense introduced any environmental taxes or levies. The role that taxes may play as a fiscal lever to influence behaviour and achieve environmental goals is yet to enter the mainstream debate in India.

Is there a shift from direct to indirect taxes?

India has, in a sense, always had a greater reliance on indirect taxes than direct taxes and if anything the trend observed in other countries of a move towards a higher proportion of indirect taxes is reversed in India. It has historically been easier to tax the consumption of goods and services indirectly than trying to tax incomes. A significant proportion of economic activity – primarily in the agricultural sector – continues to take place outside of the direct tax system. India is seeking to increase the overall tax-to-GDP ratio and is focused on raising the proportionate contribution of direct taxes to overall tax revenues.

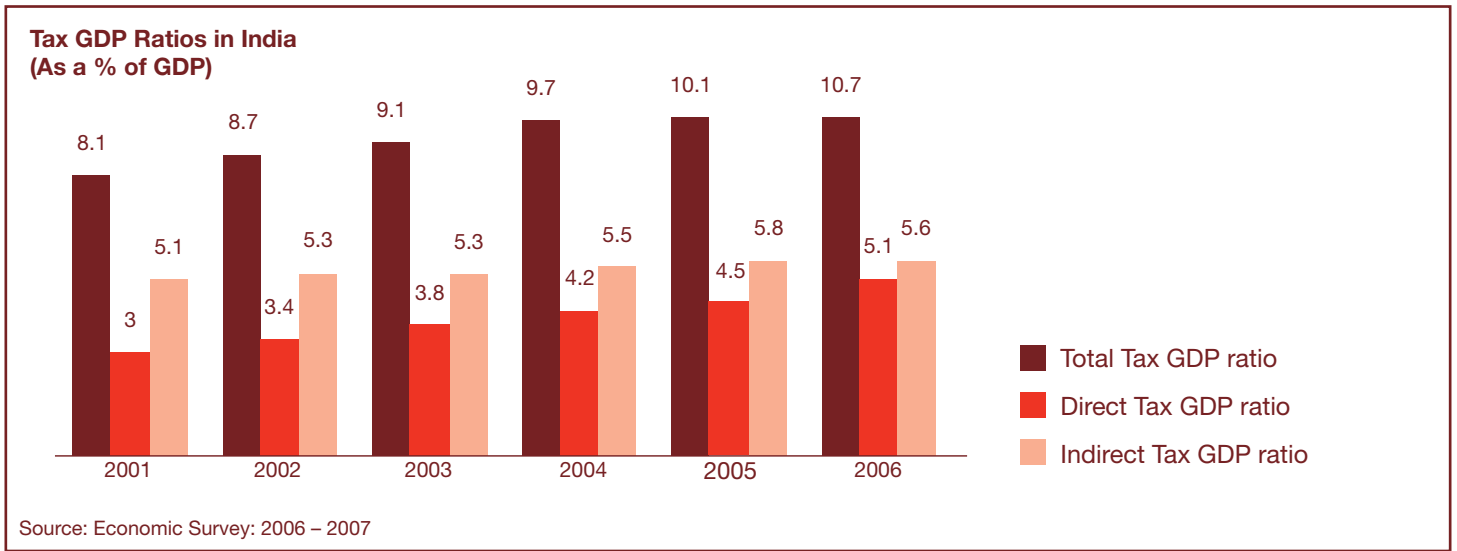
The trend of the tax GDP ratios in India over the past seven years is shown in the chart opposite.

Barriers to doing business and the need for reform

The introduction of a unified GST will address the long-established recognition that the current, multi-layered system is excessively complex and creates a compliance burden for businesses. An integrated system of indirect taxation is a vital element of creating a truly common market for goods and services in India.

Other indirect taxes, such as customs duties, are not seen as erecting major barriers to trade and India has taken significant strides towards reaching its aim of achieving equivalency with the rates in ASEAN countries. To that end, rates have already been cut to 10 per cent with an indication that they will be cut further to between six and eight percent in the near future.

India's policymakers have recognised that as an increasingly important international market and the destination for considerable foreign investment, India needs to provide a tax regime that, to the greatest extent possible, integrates closely with the rest of the world. Replacing the current arcane system with a more simple and transparent indirect tax regime is a stated policy aim, but this has to be balanced against the need to make sure that the change is gradual



and manageable rather than causing major upheaval by being excessively radical. While the benefits of establishing GST across the country are clear, the approach is best characterised as evolutionary rather than revolutionary.

The ongoing tax reform is intended to ensure that India is seen as a place that is open to business, providing a transparent and integrated system of indirect taxation. Accordingly, there are opportunities from this process but there are also likely to be challenges. Businesses need to start preparing themselves for the switch and to engage with the tax authorities to ensure that the GST system that emerges is as user and business-friendly as possible.

Compliance, technology and anti-avoidance

Both state and federal governments have recognised that information technology has a crucial role to play in the delivery of the reform agenda. Therefore, at the federal level, taxpayers are now able to (and indeed the larger taxpayers are mandated to) file returns and pay taxes electronically. This ability and stipulation applies equally for direct and indirect taxes.

Information technology has played a significant role in achieving the transition from sales tax to VAT at the state level, and there are ongoing development efforts to improve internal processes within the state tax offices and to extend the ability for taxpayers to file and pay electronically. Technology is seen as a powerful enabler of the tax reform process.

There is a significant amount of indirect tax-related litigation in India. Historically, the pro-revenue stance of the tax administration has led to taxpayers relying on the legal system to achieve solutions to their tax-related business problems. India's robust legal framework enables businesses to make use of the courts in order to validate their tax positions. The introduction of advanced rulings, available from the Advance Rulings Authority, is still in its relative infancy and is not as pervasive and robust as perhaps it needs to be. It therefore remains to be seen how far businesses will be prepared to seek advanced rulings in preference to their current first impulse which tends to be to seek recourse in litigation.

There has been considerable progress in the levels of voluntary compliance seen in India. Tax rates have moderated over time and with the introduction of IT, the threshold levels for non-compliance have moved up significantly and penalties have been considerably strengthened. A combination of these factors has generated a greater willingness to comply and this, allied to the revenue authorities' increasingly sophisticated audit capabilities, means that compliance is at demonstrably higher levels than it was even a few years ago. Until the unified GST is introduced, however, businesses are still able to make use of significant arbitrage opportunities between state and federal taxes to create more tax efficient structures. These opportunities will persist until the uniform GST is introduced.

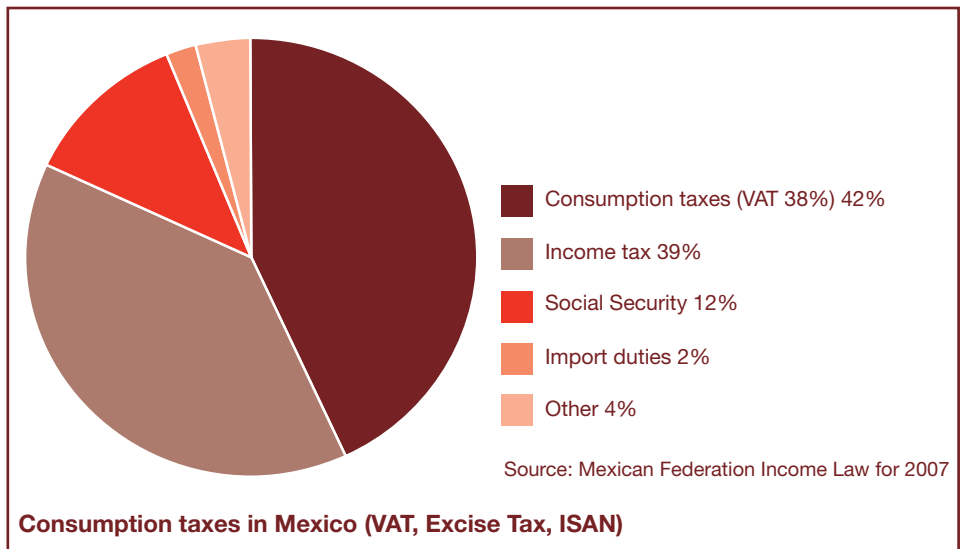
Despite rising levels of compliance, fraud and tax evasion both continue to provide cause for concern. India has a significant informal economy from which no taxes are paid. The government is trying to address this in a number of ways. For example, it is ensuring that there are robust audit and anti-fraud mechanisms in place and that the revenue authorities are paying particular attention to those sectors of the economy where tax fraud and evasion are most rampant. Special audit teams have been created that are fully supported with dedicated laws providing them with considerable powers to enter premises and seize property.

Mexico

What are the main relevant indirect taxes?

Mexico operates a VAT system, alongside a number of other indirect taxes that together account for almost half of total non petroleum tax revenue. VAT alone generates approximately 38 per cent. The adoption of VAT has not been without controversy in Mexico and it continues to generate considerable political debate. For example, there is significant resistance from some sections of Congress to the Mexican administration's desire to extend VAT to food and medicine. This resistance is in the context of a more general reluctance to accept VAT as a progressive form of taxation and opposition to other tax reforms that have been mooted in Mexico, such as the introduction of a flat tax. However, these ideas have not yet achieved the status of formal proposals, to be seriously discussed, given the delicately balanced nature of political power in the Mexican Congress.

The pie chart below shows the proportion of VAT revenues compared to other tax revenues in Mexico:



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VAT applies on permanent imports of goods and on sales, services and leasing. Most medicines and foodstuffs are zero-rated and there is a reduced rate of 10 per cent (compared to the normal rate of 15 per cent) that applies to transactions taking place within 20 kilometres of the northern and southern borders of the country and in some other specific areas. This is explicitly aimed at making sure that there is a reduced incentive to buy from over the border in the US and Central America.

There is a strong sense that the VAT system is still developing in Mexico. There is a substantial informal economy, which means that many people operate outside of the scope of the formal tax system. The development of VAT is seen as providing an effective mechanism to ensure that at least some of the informal economic activity is captured by the tax system.

Mexico also operates a specific excise tax – the Special Tax on Production and Services – applied to various products including alcoholic beverages, tobacco, gasoline and diesel. There is also still a strong will in parts of the Mexican Congress to extend the scope of this tax to include soft drinks, despite the recent successful legal action of two leading soft drinks manufacturers against the Mexican government over the taxation of these types of beverages.

There is also a tax on the possession and use of vehicles, introduced initially as a temporary funding mechanism for the construction costs of the 1968 Olympics in Mexico City. This is now a major source of revenue for the Mexican government.

An additional tax – the ISAN – applies to sales of new cars to consumers, or importation of such cars by consumers. This tax has recently been revised as detailed below.

Significant recent developments

The ISAN tax on new cars has been amended to remove cars below a certain value (USD\$14,000) from

the tax altogether. At the other end of the spectrum, cars that cost in excess of USD\$27,500 to purchase will now be subject to the highest rate of 17 per cent of the purchase price and there are new bands that will see the tax imposed at progressively higher rates.

Is there a shift from direct to indirect taxes?

The introduction of VAT signalled Mexico's alignment with the global trend of moving towards indirect taxation and away from more direct tax on income and earnings. However, in recent years that momentum has stalled in Mexico, and there is unlikely to be any major changes in the foreseeable future. The political situation, with the absence of a clear majority in Congress for any party, means that any major development is unlikely to take place in the course of the next two to three years, regardless of the recommendations made by the OECD in this respect.

Barriers to doing business and the need for reform

Though the VAT system is not seen as presenting any major barriers per se to doing business, there is a general desire and need for the system to achieve greater transparency and efficiency. There are three rates (15 per cent, 10 per cent and 0 per cent) that apply in different circumstances and contexts. There are also numerous exemptions that apply according to a wide variety and combination of situations and conditions such as some sales by foreign entities, temporary importations, specific products and services, and so on.

The resulting complexity means that it can be challenging for taxpayers to understand the correct tax position and this can retard the payment of VAT, as well as its recovery. The same situation also applies in relation to customs duties and the various free trade agreements that Mexico has with trading partners around the world. The absence of clarity and transparency with regard to a number of exemptions and special conditions can make it more complex than necessary for taxpayers. The rules on the place of

supply are very specific, subject to a combination of factors and are not internationally harmonised.

Progress to reform is, however, likely to be slow. The political environment and the continued debate about the progressive or regressive nature of the VAT system is an ongoing debate in Mexico, with little prospect of resolution likely in the short term.

Compliance, technology and anti-avoidance

Taxpayers tend to exhibit a high degree of voluntary compliance. However, as noted above, there is a significant informal economy in Mexico that remains resolutely beyond the scope of the tax authorities. The visibility of VAT is sufficiently high that compliance is not perceived to be such a major issue as it is for income tax in Mexico. There are strict rules on invoicing making it very clear and simple to calculate and assess the monies owed to the tax authorities. In addition, there is little evidence of tax avoidance by larger companies.

To date, the Mexican VAT processes have not been fully automated, with the system remaining paper-based. However, there are preliminary investigations underway and the Mexican tax authorities are consulting and engaging with various parties, including PwC Mexico, to start on the journey of automation.

E-invoicing is currently being assessed, although there has, to date, been no practical outcome of those early stage investigations. Interestingly enough, it is mandatory for reports to be delivered to the Tax Authorities by electronic means.

The nature of the Mexican VAT system means that litigation tends to focus on collections and recovery rather than arising from questions of uncertainty or challenges to the interpretation of the law. The occasionally slow-moving and complex nature of tax administration means that form, rather than substance, is the driver of legal proceedings related to VAT.

The Middle East

What are the main relevant indirect taxes?

Currently, the primary indirect taxes in the Middle East region are customs duties imposed on imported goods. These duties are generally imposed at high (in some cases, very high) rates and are discriminatory in nature. Those countries that do not have a VAT as part of their taxation system generally impose high rates of customs duties.

However, as countries in the region enter into free trade agreements, such duties are being reduced and replaced by a VAT or GST system. Lebanon, Jordan and Egypt already operate a VAT system, primarily as a revenue replacement for a reduction in customs duties resulting from free trade agreement commitments. Libya also has a VAT system.

In Lebanon, for example, customs duties on imported goods accounted for approximately 60 per cent of government revenue in 2001. In some cases, customs duties reduced from 300 per cent to 30 per cent.

In relation to other countries in the region:

- Yemen was scheduled to implement a VAT in 2007. This has been deferred until 2009.
- Syria is also likely to introduce a VAT in the not too distant future as it moves to continue the reform of its tax system and enter into bilateral and regional trade agreements.
- The countries that comprise the Gulf Cooperation Council (GCC), Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates, are currently involved in free trade agreement negotiations that, if successfully concluded, will result in significant reductions in customs duties. In many of these countries, a VAT is likely to be implemented as a revenue substitute.
- Iran drafted a VAT law in 1990 but has yet to implement a VAT, primarily because of concern as to its potentially regressive nature.



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The table below illustrates which countries have VAT and details the VAT rates.

Significant recent developments

There is a general move towards the adoption of VAT by countries in the Middle East. However, given the diversity of the region and the different stages countries are at in negotiating free trade agreements, there are significantly different rates of progress towards the introduction of a VAT.

In those countries that currently have a VAT, its introduction also provided the impetus for some important changes to the way tax is administered in those countries and a general reduction in the rates of other taxes, particularly income tax.

The Lebanese experience

Lebanon introduced a 10 per cent VAT in February 2002. This also coincided with a substantial reduction in customs duties, primarily as a result of Lebanon entering into free trade agreements. At the same time, Lebanon changed the way in which it administered its taxation system.

In particular, it moved to a self assessment system supported by risk-based auditing techniques. The move to a VAT also provided the impetus for Lebanon to make significant changes to their income tax system.

The VAT rate in Lebanon is expected to increase to 12 per cent in 2008, 14 per cent in 2010 and 18 per cent in 2015.

Jordan and Egypt – a staged approach

The experience in Jordan and Egypt is similar, although both countries implemented a VAT in stages.

Jordan introduced a GST (“VAT”) in 1994 but imposed it only on goods at the manufacture and import level and on certain services. By the early 2000s, VAT was also applied to goods supplied at the retail level and to a broader range of services. Customs duties were also substantially reduced during this time.

The Jordanian income tax law was also substantially amended. Rates were reduced and tax holidays abolished. A separate tax authority was established and subsequently merged with the income tax department. The administration of both taxes improved, and continues to improve, considerably.

Country	Introduced	Standard rate*
Egypt	1991	5% & 10%
Jordan	1994	16%
Lebanon	2002	10%**
Iran	1990 – Drafted VAT Law – still to implement	
Yemen	Expected in 2009	
Libya	Currently no VAT	
Syria	Currently no VAT	
Bahrain (GCC)	Currently no VAT	
Kuwait (GCC)	Currently no VAT	
Oman (GCC)	Currently no VAT	
Qatar (GCC)	Currently no VAT	
Saudi Arabia (GCC)	Currently no VAT	
UAE (GCC)	Currently no VAT	

**Likely to increase to 12% (2008), 14% (2010) and 18% (2015)

Egypt introduced a GST (“VAT”) at the import and manufacturing level for goods in 1991. By 1995 the VAT applied to a broad range of goods and services. There are currently two rates of GST, 5 per cent and 10 per cent. The reasons for implementing a VAT were the same as in Lebanon and Jordan – free trade agreement commitments. Egypt has also unified its tax system and is currently modernising its administration in order to retain and attract foreign investment and improve compliance.

Syria and Yemen

Syria is currently reviewing its taxation system with a view to diversifying its sources of revenue. A VAT is being considered as part of that review. As in Lebanon, Syria is also looking to make structural changes to the way taxation is administered, including a shift to self assessment and risk-based auditing. Syria is also looking to improve the regulatory framework for the business sector.

Yemen has also announced that it will implement a VAT. Significantly, the VAT was due to commence in 2007 but has been deferred until 2009.

The GCC countries

The GCC countries have economic considerations, other than free trade agreements, which make a shift to a VAT more likely. For these major oil and gas producing countries, a move to a VAT allows their economy to be less susceptible to fluctuating prices for oil and gas. This may not be such an issue when oil and gas prices are high. However, these countries have significant fixed costs. These costs do not ebb and flow with the market price of oil and gas. Another more flexible, counter-cyclical revenue source is required.

With this in mind and the impending impact on revenues from free trade agreements, it is not surprising there has been increasing discussion about the merits of a broad-based VAT for the GCC countries. It is also worth bearing in mind, that the discussion of a five per cent

VAT rate, if correct, would make it one of the lowest VAT rates in the world.

The introduction of VAT will be a significant development for many of the countries in the region, and means it is unlikely that any other form of indirect taxation is likely to be considered in the foreseeable future. However, the move away from customs duties to VAT may well lead to analysis of other tax possibilities.

Barriers to doing business and the need for reform.

As noted above, the development of VAT systems in Lebanon, Egypt and Jordan are still at a relatively early stage. As such, systems are improving considerably, but from a fairly low base. Therefore, taxpayers may experience some delays in payment of refunds or some degree of inefficiency in dealing with the tax administrations. However, the revenue authorities are seeking to improve their processes and raise their levels of efficiency and are developing the means to implement greater automation.

In many countries throughout the region, there are many ‘hidden’ taxes and charges. These can significantly add to the cost of doing business in these countries and often result in a cascading of the various taxes and charges. The removal of many of these charges and a consequential increase in the rate of a VAT (or a proposed VAT) should be considered by countries throughout the region.

Compliance, technology and anti-avoidance

In those countries which operate a VAT, voluntary compliance is generally high. The reason for this tends to be two-fold. These countries often have a high registration threshold and relatively low (by European standards) VAT rates. The combination of these two factors also reduces the tax administration’s cost of managing the system.

Automation

Egypt, Jordan and Lebanon are introducing more automation of their internal administrative processes and are increasingly offering taxpayers the possibility of filing returns and making payments electronically.

Should the GCC countries pursue a path towards VAT, it is highly likely that each will have highly automated compliance systems. As each country is essentially starting with a clean legislative sheet and few boundaries in terms of any existing tax administration, it is likely an approach based heavily on technology tools and applications would be deployed.

Most countries in the region are at different stages in their evolution to a VAT system. In relation to those that have an existing system, businesses should monitor and address the various changes likely to be made over time as they arise.

In relation to those countries likely to introduce a VAT in the not too distant future, once a decision to introduce a VAT is made, it is probable that governments will rapidly move towards implementation. Therefore, businesses should start high level planning for a series of VAT implementation projects in order to understand the likely cost, resource commitment and business impact.

South & Central America

What are the main relevant indirect taxes?

Countries in South and Central America are different in so many ways, and the application of indirect taxes is no exception to this observation. Most of the countries in the region have adopted a 'standard' single VAT system. The exceptions are Brazil, that operates four separate forms of VAT, and a small number that operate with only a sales tax or no sales tax at all. Most countries have adopted a single VAT and in some countries there is an excise tax that works as a de facto VAT.

In most cases, VAT works formally in much the same way as a traditional VAT applied in Europe. Value-added taxes are imposed on goods and services, operate as a credit/debit system, and are also applied on the importation of goods and services in general. However, of course, there are particularities within each country and no signs of harmonisation of tax systems between countries, even in areas of trade and economic cooperation. Each country has constructed its own indirect tax system around its own needs and circumstances. Even in Mercosur,¹ the largest and most advanced of the regional trade agreements, harmonisation efforts have focused exclusively on duties and the duty system. Members' respective VAT systems have not been considered to date despite the fact that their harmonisation was an explicit aim from the outset of the organisation.

Most countries in the region operate with a federal VAT, the exception being Brazil where VAT is imposed at the state level. The rates imposed are broadly comparable with those of the EU, with the major regional economies such as Argentina, Chile, Venezuela and Colombia operating with rates that vary from 15 to 20 per cent.



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¹Mercosur is the economic grouping comprising Brazil, Argentina, Uruguay, Venezuela, and Paraguay as full members and Bolivia, Chile, Ecuador, Colombia and Peru currently as associate members.

Significant recent developments

There has been a noticeable trend in the last 12 months for tax authorities across the region to focus on VAT as a means to increase the total tax revenue that they collect. This has arisen for a variety of reasons, notably the greater and more sophisticated use of technology and the development of electronic invoicing and payments systems. The tax authorities generally are becoming more technologically advanced. In Brazil, for example, the tax authority has facilitated companies' use of more advanced technology tools such as e-invoicing with the result that more companies, particularly larger ones, are making use of these methods. Argentina, for example, is also investigating the introduction of e-invoicing as well as using technology to drive simplification and achieve greater process efficiency.

Most countries in the region are similarly looking for ways to simplify tax returns and make it easier and more efficient to comply with the VAT system. Again, the aim is to make compliance more pervasive and straightforward in order to maximise the volume of taxpayers that the authorities can deal with effectively. Countries in the region are also in line with global trends to broaden the base of goods and services to which VAT applies.

There has been little recent development in terms of other indirect taxes. With the notable exception of Costa Rica (which has historically operated with a far-sighted approach to the preservation of the environment), few countries have introduced indirect taxes that aim to discourage or compensate for activities or consumption that may be seen as damaging to the environment or accelerating climate change. Some countries impose licence fees on companies that wish to engage in certain activities in particular regions. But considering the global momentum behind environmental issues, it is highly likely that there will be more active consideration of environmental taxes sooner rather than later.

Is there a shift from direct to indirect taxation?

There is certainly evidence of a clear shift from direct to indirect taxes in the region. For example, in Brazil over the last two years (2005 and 2006), indirect taxes accounted for more than 50 per cent of all tax revenues. VAT alone in 2006 was 30 per cent of the total tax collected. The relative simplicity of VAT, and the drive by many tax authorities to focus on simple and efficient tax collection, explains why indirect taxes – and VAT in particular – are becoming an increasing area of focus. Indirect taxes are perceived as easier to administer than the more complicated computational requirements arising in a complex international commercial environment. Of course, this is not simply true of Latin American regimes, but is consistent with a global trend to focus on the certainty of the revenues arising from VAT.

The percentage of VAT to total tax collected in Brazil as per the Brazilian National Treasury official statistics is detailed below:

	Brazil Total Taxes Collected (%)	
	2005	2006
Income tax	26.2%	29.5%
ICMS (State VAT)	28.0%	30.2%
PIS / COFINS (Federal VAT)	20.1%	20.8%
IPI (Excise Tax)	6.8%	5.0%
Others	18.9%	14.5%
Total	100%	100%

Brazilian National Treasury official statistics, March 2007

Barriers to doing business and the need for reform

The significant variations between countries in the region inevitably mean that some VAT systems in Latin America create higher barriers to doing business than others. For example, importation of services to Brazil is subject to VAT which makes the cost of importing services more expensive than compared to elsewhere.

The cost of compliance is very high in Brazil, when compared to other countries, and this can create a competitive differentiation between countries. Some countries, notably Chile, have addressed the need to create a stable, simple and transparent system and they have been very successful in applying those principles in order to minimise the compliance burden and remove unnecessary barriers to doing business for taxpayers.

Conversely, in some countries tax systems have become more burdensome for taxpayers, and have in some instances taken on a political dimension, with the revenue authorities adopting an increasingly aggressive approach to the business community. In Venezuela, for example, there have been instances of companies being effectively closed for a number of days owing merely to very minor errors emerging from an audit.

Though each country necessarily has its own specific requirements in terms of reform, there are two broad directions for reform that it would arguably be useful for all countries in the region to pursue. The first would be to seek greater simplification of VAT systems, thereby reducing the cost of compliance. And the second, and related, would be in the form of a commitment to stability in the tax regime reinforced with statutory commitments to maintain that stability over a particular period. This would give taxpayers the chance to plan effectively and operate with the knowledge that VAT rules would be applied consistently over a given timeframe.

Compliance, technology and anti-avoidance

Several countries in the region are harnessing technology to automate many of the processes required for an effective and efficient system for VAT compliance. Brazil is probably leading in the use of technology, but Chile is also making rapid strides in this direction with Peru also moving towards a technology-based VAT system. These initiatives are largely welcomed by taxpayers.

Less welcome for most taxpayers is the significant amount of uncertainty in tax systems. They are subject

to significant and often rapid change and this, in turn, drives a considerable amount of litigation. Taxpayers broadly agree that this inherent lack of stability is the major challenge that they face in complying with their VAT obligations. For this reason, litigation is a common feature of VAT systems in the region. In some countries, such as Brazil, the revenue authorities are constitutionally bound to litigate a wide number of cases and it is generally not possible to reach advanced and binding agreements that allow taxpayers to operate in a particular way with the certainty that they will not suffer adverse consequences from doing so.

In terms of voluntary compliance there is a clear distinction between the large corporations, who exhibit high levels of voluntary compliance, and their smaller counterparts, where the picture of compliance is more mixed. For many smaller companies the overall burden of taxes is at very high levels and non-compliance is often seen more as a matter of economic necessity rather than a wilful disregard for the rules. Though tax evasion has been significantly reduced over time, a considerable unofficial economy operates in many countries, particularly in rural areas.

For most countries the penalties for evasion are very high, and there are serious criminal sanctions against tax fraud. There is also an attempt in countries, such as Brazil, to use media campaigns to create a negative public opinion of tax evaders, specifically in relation to VAT.

United Kingdom

What are the main relevant indirect taxes?

The UK operates a standard VAT system under the European model and taxes are administered and collected by Her Majesty's Revenue and Customs (HMRC), the agency that was formed following the merger of The Inland Revenue (responsible for direct taxes) and Customs & Excise (responsible for VAT and other duties) in April 2005. A notable feature of the UK's VAT regime is the concerted attempt made to reduce the burden of the tax on small businesses. As an example of this, the VAT registration threshold is the highest in the EU and this is designed to keep the smallest businesses out of the VAT net. There are also various schemes designed to simplify VAT accounting for the smallest businesses, such as cash accounting and annual VAT returns for the smallest traders. In this way, the UK tries to eliminate the burden of VAT administration as much as possible for small businesses.

At 17.5 per cent, the standard rate of VAT in the UK is relatively low compared to other EU member states (the standard rate must be set in a range between 15 and 25 per cent). The UK also maintains a fairly extensive zero rating on social goods and services, in contrast to most other EU member states that operate with a reduced rate on social items.

The main indirect taxes operated in the UK that impact on businesses and individuals are:

- VAT
- Customs duty on exports from outside the EU
- Excise duties on a range of goods (principally tobacco and alcohol)
- Insurance premium tax
- Stamp taxes



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There are also a range of environmental taxes:

- Air passenger duty
- Car fuel duty
- Climate change levy – principally applied to power producers
- Landfill tax
- Aggregates levy

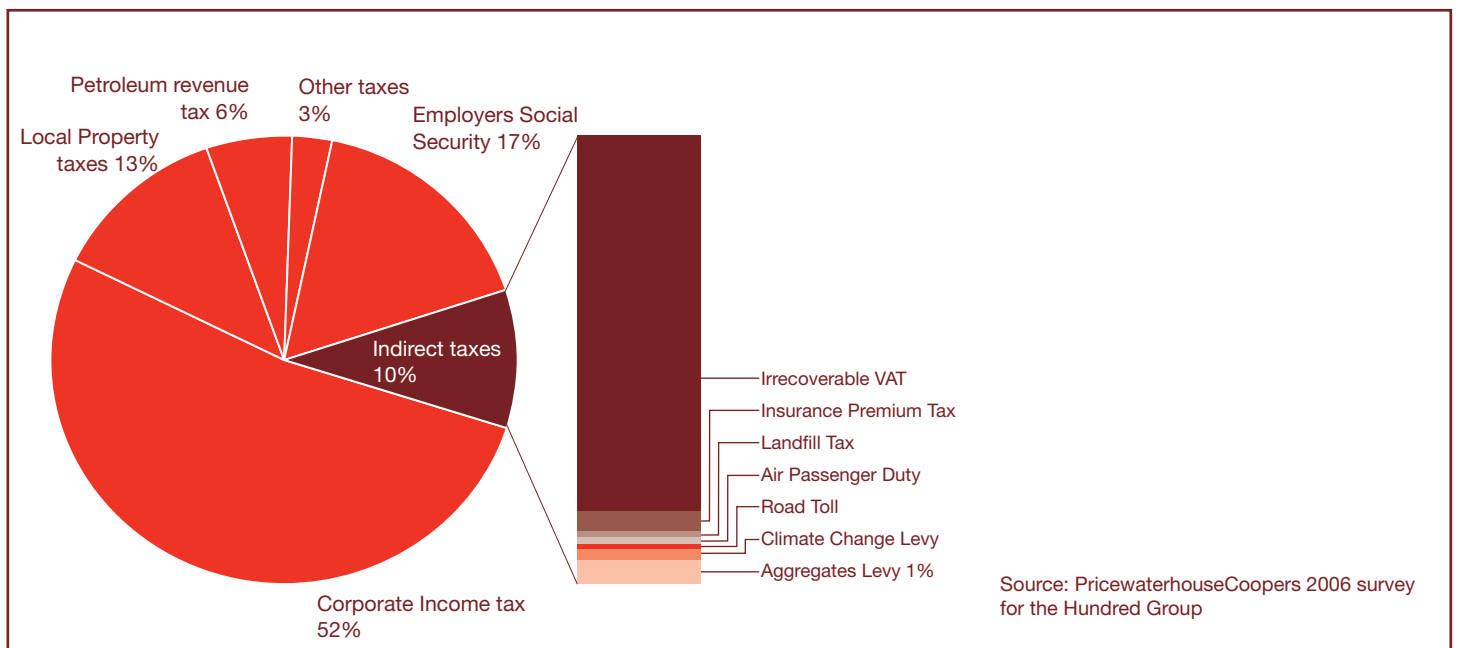
The chart below illustrates that indirect taxes are a significant part of the taxes borne in the UK.

Significant recent developments

The major development in the UK has been a clampdown on tax fraud and, in particular, the so-called ‘missing trader’ fraud. Estimates suggest that this fraud has cost the UK between £3 billion and £4.75 billion annually. Consequently, a concerted drive has been put in place to combat the fraud with considerable success

in targeting criminals engaged in this activity. However, there have been some less welcome consequences. The record-keeping requirements that have been introduced for businesses in the sectors in which the fraud is most prevalent – particularly consumer electronics – have placed a considerable administrative burden on many perfectly legitimate businesses. In addition, the increased rigor and scrutiny applied by HMRC to the payment of VAT refunds to businesses in those sectors means that many businesses have suffered significantly adverse cashflow impacts.

The UK has proposed a more permanent solution to close out the possibility of missing trader fraud arising from the abuse of intra-EU trade, by changing the method of accounting for the VAT in these circumstances. This means that rather than the supplier charging for VAT on goods, the customer self-accounts for the tax, thereby eliminating the possibility of the supplier committing the fraud in the first place. Though this proposal was originally blocked by one or two EU member states, the Commission has recently approved



UK government receipts from taxation 2001 – 2007 [£million]

Fiscal year	Indirect Taxes	Direct Taxes	Total	% Indirect
2001-2002	113,168	208,599	321,767	35.2
2002-2003	117,401	207,330	324,731	36.2
2003-2004	124,595	219,269	343,864	36.3
2004-2005	131,211	239,864	371,075	35.4
2005-2006	134,172	264,195	398,367	33.7
2006-2007*	139,737	284,976	424,713	33.0

*2006-7 figures based on Government's Pre-Budget Report, as final figures not yet available at time of publication.

Indirect taxes included above, and listed in descending order of revenues are:

VAT
 Fuel duties
 Stamp duties
 Tobacco duties
 Beer duties
 Wine duties
 Insurance Premium Tax
 Customs duties

Petroleum revenue Tax
 Spirit duty
 Betting & Gaming duties
 Air Passenger Duty
 Landfill Tax
 Climate Change Levy
 Aggregates Levy
 Cider & Perry duties

Direct Taxes included above, and listed in descending order of revenues are:

Income Tax
 National Insurance Contributions
 Corporation Tax
 Capital Gains Tax
 Inheritance Tax

the application – perhaps out of concerns that the fraud is now starting to appear as a serious issue in other member states.

A further trend in the UK has been the strong stance taken by HMRC against VAT avoidance. In particular, two measures have been introduced over the last few years that demonstrate this stance. The first of these is a requirement on any business implementing certain schemes to notify HMRC. In addition, HMRC has drawn up a list of certain features that it believes to be hallmarks of avoidance. These include features such as transactions being routed offshore, and confidentiality clauses in arrangements with advisers. If these are

present in any scheme used by a business, HMRC must be informed.

The second feature is a markedly more aggressive approach to litigation. The number of VAT tribunals has increased considerably and whenever HMRC loses a case, there is a tendency to appeal to the next stage, deliberately making litigation as difficult and onerous for a business as possible. Although there is a strong body of case law that defines the ways that businesses can mitigate tax legitimately, HMRC continues to pursue individual cases, even where the case law would tend to suggest that the planning at issue is legitimate.

Is there a shift from direct to indirect taxes?

The standard rate of VAT – the major contributor of revenues to government coffers among indirect taxes – has remained unchanged in the UK since 1991, so to this extent there has been no obvious shift. If one examines annual taxation receipts in the UK, the years 2001-2 to 2003-4 saw an increase in the proportion of receipts arising from indirect taxes from 35.2 to 36.3 per cent. However, based on projected receipts for the fiscal year ended 2007, the anticipated proportion relating to indirect taxes is expected to fall to 33 per cent. The revenue authorities believe that one explanation for this is the significant revenue loss arising from missing trader fraud, as outlined previously.

Going forward, it is unlikely that any wholly-new indirect taxes will be announced in the UK in the short term, but what is almost certain are increased rates and coverage in a number of areas over the next two or three years, particularly in the environmental area, such as the climate-change levy, landfill tax etc.

Barriers to doing business and the need for reform

In general terms, the UK's VAT system and revenue authorities are seen as predictable and transparent, presenting few problems to businesses when making their location and investment decisions.

However, there are some specific sectors in which VAT is a more problematic issue. Principal among these is the financial services sector. The trend towards outsourcing has been strong in financial services, but because financial services are exempt from VAT, businesses in the sector are unable to reclaim the VAT that they pay on services, such as back-office or IT support, that are provided by a third-party. This means that financial services firms are potentially unable to benefit from the cost and efficiency advantages that outsourcing provides. Though negotiations with the HMRC have taken place over this issue, the revenue authority has been somewhat inflexible in its insistence that VAT should be chargeable on all outsourced services, indicating a short-term focus on tax revenue

rather than a willingness to adopt a wider view of the economic implications.

This wider view is, however, being considered at a European level. The EU has commissioned a report (carried out by PricewaterhouseCoopers) that is examining the way in which VAT is levied in the financial services sector and it is highly likely that there will be reform in the near to medium term as a result.

An additional area where reform is needed arises from instances where business, social and economic developments have taken place in a way that could not have been foreseen when the original VAT legislation was drafted. A prominent example is the shift from printed to online media for many journals and periodicals. Subscribers are liable to pay the tax depending on whether they choose to receive a printed (zero-rated) or online (fully-taxable) version of the same product and so harmonisation is required to correct this imbalance.

A further example of the tax standing still and the world moving on applies to some categories of social relief. When the legislation was first introduced, a particular world view held sway that has long since been superseded. More than thirty years ago, disability was framed in the legislation as relating purely to physical impediments, and the range of VAT relief available on items targeted accordingly. Now that a much broader and holistic view of disability is current, the tax legislation and the eligibility for relief needs to change in order to reflect contemporary views.

Compliance, technology and anti-avoidance

The UK has a strong compliance culture with relatively few businesses actively fraudulent in their approach to VAT.

Technology has been used increasingly for compliance and tax audits over a number of years and its use will continue to develop. HMRC has used software to take data downloads and analyse them and the trend towards e-auditing will continue for reasons of efficiency

and the ability to more comprehensively identify errors. Businesses are also increasingly using technology to address the efficiency and accuracy of their own VAT collection. This includes building-in some of the HMRC tests to their own data analysis in order to spot errors and pre-empt potential problems in VAT accounting and related processes.

The number of VAT tribunals has increased and we expect this trend to continue. This is partly driven by the increasingly aggressive approach taken by the tax authorities, but is also due to the continued areas of uncertainty, and therefore legitimate differences in interpretation, to which the VAT legislation gives rise.

United States of
America

Overview of the indirect taxation system

The United States is unique among major industrialised countries in having no system of VAT or broad-based consumption tax at the national level. In terms of other indirect taxes, the US Federal Government (like other governments across the world), does levy a number of excise-style taxes on selected goods such as alcohol, cigarettes and gasoline. However, the collective impact of these taxes is relatively small, accounting for about three per cent of total federal tax revenues.

While there is no nationally-applied system of consumption tax, the concept is very much in evidence at the state, county and city level. The various levels of US subnational governments are responsible for raising more than a third of the total government tax take, and about one fourth of this revenue comes from general sales and gross receipts taxes. Some 45 states and the District of Columbia levy retail sales taxes, which usually range between four and seven per cent of the purchase price of the goods being sold. Like the VAT systems in other countries, this is a broad-based consumption tax. But unlike VAT, it is only collected at the retail level, and not on every business-to-business sale.

The world-renowned complexity of the US sales tax system springs from the situation below state level, where some 7,000 localities levy their own retail sales taxes, which can vary widely both in terms of the rates at which they are levied and of the goods that they include or exclude as taxable items. They may also have separate filing and registration requirements from the state-level retail sales taxes.

Significant recent developments

In an attempt to reduce this complexity, a recent trend has seen many states voluntarily decide to adopt the provisions promulgated by the Streamlined Sales Tax Project. The stated aim is to simplify the administration and impact of the retail sales tax system. One further reason for the states' move towards streamlined sales tax is their long-standing and growing concern over 'remote sales' – retail transactions conducted either by mail order or over the internet.



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By law, states have the right to levy retail sales taxes on transactions where the retailer is located within, or has a physical connection with, their particular jurisdiction. In cases where the retailer has no physical connection with or presence in the state, then states' laws usually provide that the customer should report the transactions, self assess, and pay the relevant retail sales tax. This is the so-called 'use tax' that complements the sales tax. Not surprisingly, compliance with the use tax requirement among individual consumers tends to be very low, even in states that include questions about it on local income tax forms.

Historically, states resorted to legal action to try and recover the use tax from mail-order retailers without a within-state presence. However, such attempts have failed to date, with the US Supreme Court having ruled that it was unconstitutional for the states to require remote sellers to collect sales or use taxes, taking the view that this would represent an 'undue burden' on the businesses concerned.

The states are hoping that by taking voluntary steps to simplify the sales tax system through the adoption of the streamlined sales tax, they will win over enough members of Congress to introduce legislation enabling them to require out-of-state retailers to collect and pay the use tax. The jury is out on whether the states will succeed with this agenda. However, the revenue at stake may ultimately be limited by the fact that an increasing number of remote sellers are deciding that they need some form of local presence to grow their sales, thereby bringing themselves within the ambit of the state's sales tax.

Is there a shift from direct to indirect taxation?

There is no discernible shift from direct to indirect taxation either at the federal or state level. The latest figures show that the US relies far more heavily on income tax revenues than the average OECD country and has the second highest corporate income tax rate (39.3 per cent including federal and state taxes), only

narrowly behind Japan and ahead of Germany. How long the US business community will put up with having one of the world's highest corporate tax rates remains to be seen. One clear trend on the direct tax front is for states to move their income tax levy from a net to a gross receipts basis, to gain more predictability. However, these 'turnover' taxes are resulting in tax cascading because taxes are collected multiple times as sales occur within the supply chain (with no offsetting credits).

Barriers to doing business and the need for reform

There is no sign that the US Treasury is looking at a fundamental reform of the tax system, such as a shift towards the type of national VAT-style consumption tax system seen in most other countries. A report from a President's Advisory Panel on tax reform did suggest a national cash flow tax as one possible option, but this would not have been structured as VAT, and the idea is now on the back-burner. The Government Accountability Office is also conducting a study of VAT, but the idea remains at an embryonic stage. A few members of Congress have proposed a national-level retail sales tax, but again this would not be like VAT, and would be used to replace rather than supplement other federal taxes.

A further area of pressure for reform of indirect taxes in many jurisdictions around the world is the 'green' agenda. However, while territories such as the European Union have seen significant increases in indirect environmental taxes, this has not happened in the US. At a federal level there are taxes levied on polluting substances such as ozone-depleting chemicals and leaking underground storage tanks. And at state level there are taxes on the disposal of tyres and other commodities. But in general, these taxes are not significant in terms of revenue yield.

Compliance, technology and anti-avoidance

As we mentioned above, consumers exhibit a relatively low level of compliance with the use tax regulations on

purchases from out-of-state retailers. However, at a corporate level, larger businesses purchasing goods as end-users do generally self-assess use tax accurately and pay the required levy. While some comply more fully than others, most corporations make efforts to fulfil the requirements. As a result, about 40 per cent of government revenues from retail sales tax come from businesses.

Here the difference between a VAT and retail sales tax system comes to the fore. In a VAT system, businesses can offset the VAT they pay against the VAT they levy on their own sales, and in the course of the supply chain the two effectively cancel out, meaning the VAT paid as goods go along the chain has a neutral impact on the end-purchaser. By contrast, businesses paying retail sales tax on purchases of goods which are consumed in their business have no way to recover it, apart from increasing the prices they charge to their own customers. The result is that the retail sales tax eventually cascades onto the end user – a distortion that underlines the shortcomings of the system.

In terms of compliance, one word that is very rarely used in relation to the US indirect taxation system is ‘fraud’. While lack of compliance with the sales and use tax regime is pervasive, especially among consumers, this is generally not due to deliberate disregard for the law but to a lack of knowledge, capability and resources. Among companies, larger corporations usually comply, and if there are serious problems over

compliance they tend to occur with ‘mom and pop’ or sole-proprietor cash businesses such as local grocery stores. The fraud cases that the authorities tend to take the most seriously are those where a business is collecting retail sales tax but not remitting it. The US certainly sees nothing on the scale of the massive VAT carousel frauds evident in Europe.

Information technology is being used increasingly by companies to ensure their compliance with the sales tax regulations through automation and ‘push-button reporting’. Several third-party developers have produced indirect tax software that integrates with ERP systems or company-developed billing systems. A more recent development is the growing usage of hosted compliance solutions, accessed on an ASP basis, a type of service that has taken off significantly within the past year.

While indirect tax fraud is rare and relatively small-scale, there are plenty of disputes and litigation, usually involving state or local authorities and generally around the tax status of retailers and their degree of connection with the state, or focusing on interpretation of the legislation and the taxability of particular goods or services. For example, since goods are subject to retail sales tax but services may be exempt, there are disputes (and differences between states), over whether downloaded software has the same tax status as that sold on CD.

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