VERTEX Exchange

VAT vs. Sales Tax: Differences, Similarities and Key Concepts

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Presenter's

- **Diane L. Yetter**
  - Strategist, advisor, speaker and author
  - President of YETTER and Founder of the Sales Tax institute
  - 30+ years tax experience in both public and private
  - Specializing in indirect tax consulting, education and automation
  - Named as one of the 100 Most Influential People in Accounting in 2011, 2012 and 2017
- **Danny Vermeiren**
  - Director VAT – Chief Tax Office
  - Vertex Inc.
  - 20+ years of VAT experience in consulting and industry

Agenda

TOPIC	TIME
Roundtable Discussions Including:	85 minutes
• High Level Comparison – VAT vs. SUT	
• How VAT Works – an Example	
• Specific Items and Key Concepts	
• Administrative Differences	
Wrap-up/Questions and Answers	15 minutes

Objectives

- Upon completion of the session, you will be able to:
  - Understand the differences between sales and use tax and VAT and how they are structured
  - Understand related, key terms and how to translate common sales tax concepts into VAT concepts
  - Learn how the different tax structures treat common scenarios for resales, manufacturing, and services
  - Understand at a high level how to determine when your business has an obligation to register and collect VAT

Polling Question #1

- Where do you collect or pay indirect tax?
  1. U.S./Canada
  2. Mexico
  3. South America
  4. Europe
  5. Middle East/Asia
  6. All

Polling Question #2

- What is your level of knowledge about VAT?
  1. What is VAT?
  2. I know we collect/pay it but not sure why
  3. I help administer it but don't understand it very well
  4. I am pretty knowledgeable about VAT

High Level Comparison of VAT and SUT

High Level Comparison

1. Scope
2. Services
3. Rates/Rate Structure
4. Input Credits
5. Exemptions

1. Scope: Sales Tax

Sales tax is a transaction tax on the retail consumption of tangible personal property and selected services

- Collected at the time of the sale
- Only the final sale is taxed
  - 45 States and DC currently impose a sales tax
  - 5 states do not have sales tax.
    - **N**ew Hampshire
    - **O**regon
    - **M**ontana
    - **A**laska (no state level but locals impose tax)
    - **D**elaware

1. Scope: Sales Tax

- Sales Tax can be imposed by the state, county, city or special purpose districts
- Sales Tax applies to sales made inside the same state
- Use Tax applies to sales made outside the state and on purchases on which no tax was charged by the seller

1. Scope: VAT

- Value added tax (VAT) is a transaction tax
  - Goods and services
  - Collected at each stage of the supply chain
  - Ultimately charged in full to the final purchasers
- Approximately 150 countries levy a VAT
- VAT/TVA/IVA/BTW/... but also GST
- VAT applies to every part of the supply chain:
  - Output tax is collected on the sale of goods and services
  - Input tax is paid to vendors on purchases of goods and services

1. Scope: EU VAT Directive

- EU VAT directive:
  - Higher legislative hierarchy than national legislation in case of derogation
  - Binding for Member State only 'in principle' – needs national legislation to be implemented
  - Direct effect for taxpayer if provisions are clear / cannot be interpreted in different ways and create direct rights for the taxpayers (i.e., not optional for countries) and the facts apply
    - Member States cannot impose additional conditions to certain rights if the Directive does not e.g., invoice requirements
    - Sometimes leaves Member States legislative options
    - Sometimes prohibits Member States explicitly from certain behavior – e.g., "member states shall not require invoices to be signed"
- National legislation
- EU court cases: application of the Directive – not on facts
- National court cases – Administrative guidelines

1. VAT: Scope: Outside the EU

- New Unions on the Rise
- Gulf Cooperation Council

Bahrain	Saudi Arabia
Kuwait	Qatar
Oman	United Arab Emirates

- Brexit impact ?

1. VAT: Scope: Outside the EU

- Canada
  - GST (VAT) at the country level
  - HST in “Harmonized” provinces operates like a VAT
  - QST is partially harmonized and operates like a VAT
  - PST is really a sales tax and operates very similar to a US sales tax
- India
  - Major tax reform – adopting a GST
  - Special rules for intra-state and inter-state transactions

2. Services: SUT

- Sales Tax: Unlike sales of tangible personal property which are generally taxable unless specifically exempt, in most states sales of services are assumed to be exempt unless specifically taxed
  - Many states have adopted the “True Object Test” where the test of whether a transaction is considered a taxable sale of tangible personal property or a nontaxable sale of services is if the purchaser's “true object,” “real object,” or “dominant purpose” was to acquire the finished product or the service
  - Because of this, service providers will generally not be exempt on their purchases of tangible personal property used in the transaction

2. Services: VAT

- For EU VAT: very broad definition of “services”: art 24 EU VAT Directive: “supply of services shall mean any transaction which does not constitute a supply of goods” , e.g.,
  - Including the obligation NOT to do something
  - Acting as an intermediary / agent for transactions
- VAT specific place of supply rules for (cross border) services:
  - B2C: where vendor is established
  - B2B: where recipient of service is established
  - Exceptions B2B: immovable services, intermediary services, passenger transport,...
- Liability to pay VAT may shift to recipient of the service to account for VAT through self-assessment

2. Rates/Rate Structure

SALES TAX	VAT
Average rate 9.6%	Average rate 19% OECD – 21% EU
Highest combined average rate Louisiana 9.98% Highest state rate 7% (IN, MS, RI, TN)	Highest rate 27% (Hungary)
Multi-level tax (down to special purpose level)	National rates (incl. reduced)
10.000+ taxing jurisdictions and rates	Fewer rates – taxing jurisdiction mostly national level

3. Input Credits

- VAT is neutral for taxable businesses; mechanism to achieve neutrality = deduction / input credit: offset the VAT paid to vendors with the VAT collected from customers
  - Example: Assume a 10% VAT rate.
  - Dealer buys a set of chairs from Wholesaler at 18,000
  - Dealer pays VAT to Wholesaler = 18,000 * 10% = 1,800
  - Dealer sells chairs to Customer for 20,000
    - Dealer collects VAT from Customer = 20,000 * 10% = 2,000
  - Dealer remits VAT to the government = 2,000 - 1,800 = 200
  - The 1,800 is considered an "input credit"

4. Input Credits

- Limitations exist to the right of deduction / input credit system:
  - If company performs activities that do not give rise to the right of deduction (e.g., banking and insurance)
  - Purchases of certain specific goods are excluded either fully (e.g., alcoholic drinks) or partially (e.g. cars)

- Right of deduction is subject to scrutiny at audit
  - formal requirements for invoices have to be met or VAT deduction will be disallowed and penalty applied

4. Input Credits

- If deductible VAT is higher than output VAT, most countries will refund the excess credit in cash
  - Same example: Assume a 10% VAT rate.
    - Dealer buys a set of chairs from Wholesaler at 18,000
    - Dealer pays VAT to Wholesaler = 18,000 * 10% = 1,800
    - Dealer sells chairs to Customer for 20,000 – this time export sale (no VAT to be collected from customer)
    - Dealer bills to Customer zero VAT
  - Dealer VAT return shows a net credit of 1,800
  - Most countries will pay back in cash, some countries will carry forward until there is an offset (if ever)

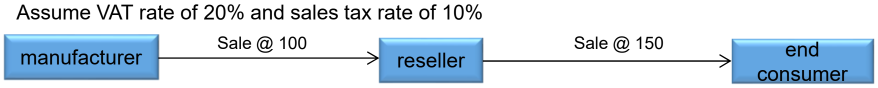
5. Exemptions

- SUT
  - PRINCIPLE = every goods transaction is taxable
  - Exemption for export
  - Exemptions for resale :
    - Ability to purchase tax free for resale
    - Valid exemption certificate to be provided by customer
    - Exemptions for resale, manufacturing,…
    - By transaction or blanket
  - Entity specific exemptions
  - Exclusions (services, real property)
- VAT
  - PRINCIPLE = every transaction is taxable
  - Exemptions with credit (« zero-rate ») :
    - Export / intra-EU supply of goods
    - Cross-border services (special rules apply)
  - Special exemptions incoming side :
    - Frequent exporter regime (Italy/France): ability to purchase VAT free with certificate
  - Special zero rates outgoing transactions:
    - Immovable works, telecom, IT… (anti-fraud measures)
    - Customer is liable for the VAT (deductible)
  - Sector specific exemptions (without credit):
    - Financial transactions
    - Not for profit / governments
    - Holding companies

How VAT Works – an Example

How VAT Works – an Example

Assume VAT rate of 20% and sales tax rate of 10%



Invoice	base	tax	Total
VAT	100	20	120
SUT	100	0 (w cert)	100

Invoice	base	tax	Total
VAT	150	30	180
SUT	150	15	165

Reseller Accounting

	VAT	SUT
Pay to manufacturer	120	100
Collect from customer	180	165
Net cash position prior to return	*60*	*65*
Balance Sheet : tax to be remitted	30	15
Balance Sheet : receivable tax	-20	0
Net tax liability	*10*	*15*
NET RESULT	**50**	**50**

How VAT Works – the Reseller

Assume VAT rate of 20% and sales tax rate of 10%

manufacturer —Sale @ 100→ reseller —Sale @ 150→ end consumer

Invoice	base	tax	Total
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Collect from customer	180
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NET RESULT	**50**

V.A.T. = Value Added Tax
i.e., the tax on the value one adds

- reseller buys at 100, sells at 150
- i.e., he adds value of 50
- tax on that added value = 20% on 50
- Equals 10

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How VAT Works – the Customer

Assume VAT rate of 20% and sales tax rate of 10%

manufacturer —Sale @ 100→ reseller —Sale @ 150→ end consumer

Invoice	base	tax	Total
VAT	100	20	120
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For:

- The same sales price of the manufacturer
- The same sales price / margin of the reseller

The price for the customer is higher

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Polling Question #3

- SUT regime is always better for the customer as it leads to lower prices

1. True
2. False

Polling Question #3 – Answer

Assume VAT rate of 20% and sales tax rate of 10%

manufacturer → Sale @ 100 → reseller → Sale @ 150 → end consumer

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Reseller Accounting

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ANSWER: False

- manufacturer and reseller will pay sales tax/accrue use tax on anything they buy that is not for resale
- as such for SUT the real cost is higher throughout the supply chain whereas for VAT it will be neutral

=> in real life, for SUT the base price would have to be higher to get the same net result

Specific Items and Key Concepts

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Typical Treatment of Retailers

- Sales Tax: Retailers are required to collect the sales tax from the end consumer and remit the tax on behalf of the consumer to the taxing jurisdiction if they have nexus with that jurisdiction
  - Retailers do not pay sales tax on items they purchase if they are going to resell the items. They do pay use tax on any items taken out of their inventory for their own use
  - Sales tax is added to the price and separately stated

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Typical Treatment of Retailers

- VAT: Retailers charge VAT on their sales and pay VAT on their purchases from their suppliers
  - Retailers can have a simplified scheme as opposed to tracking and calculating all of the sales
  - Generally, in most VAT/GST systems, price is inclusive – the price you see is the price that you pay.
    - One exception is Canada, where the GST is separately stated from the sales price, along with any applicable provincial sales tax

Nexus vs. Permanent Establishment

- Sales Tax: Whether a company is required to collect sales or use tax is dependent on whether they have nexus with the state
  - Nexus refers to links, connections, or contacts between a jurisdiction and a taxpayer
    - Company owned property
    - Company employees
    - Company agents
  - If a taxpayer has sufficient nexus with a state, it is deemed to be "doing business" in that state and will be liable for the state taxes

Sales Tax: What Constitutes Presence?

- Quill – A company has nexus in any state in which the company's property or employees are physically present on a regular and systematic basis
- What about independent agents?
  - In Tyler Pipe Industries, Inc. v Washington Department of Revenue (1987), the activities of a single independent contractor residing in Washington was sufficient to create constitutional nexus for the out-of-state principal (Tyler Pipe)
- What about affiliates?
  - In SFA Folio Collections, Inc. v Tracy (1995), the activities of an affiliated group (Saks Fifth Avenue) created nexus for the mail-order company. The affiliated group solicited for the mail-order company and accepted returns on its behalf

Sales Tax: What Constitutes Presence?

- Remote Seller Requirements
  - Click Through Nexus laws require remote sellers that pay referral/commission fees to in-state representatives that facilitate sales to collect tax
  - Affiliate Nexus laws require remote sellers that have related entities in a state to collect tax
    - Also if there are unrelated parties that facilitate the sale
- Economic Nexus laws require remote sellers that exceed sales thresholds to collect even if no physical presence
  - South Dakota v. Wayfair – the U.S. Supreme Court struck down the physical presence rule established by Quill.

Nexus vs. Permanent/Fixed Establishment

- VAT: fixed establishment: sufficient degree of permanence and suitable structure (human and technical resources) – able to receive and use services for its own
- A permanent establishment for VAT purposes is a factual inquiry. It could include:
  - Having a facility located in the country
  - Bookkeeping facilities located in the country
  - Ability to enter into contracts
- It's important to differentiate a permanent establishment for income tax purposes versus a permanent establishment for VAT purposes

Nexus vs. Permanent Establishment

- VAT: Remote seller rules
  - Sellers of electronic goods and services may be required to register in a country regardless of permanent establishment
    - Norway
    - South Africa
    - EU
    - Australia

Make a “Sale” vs. “Supply”

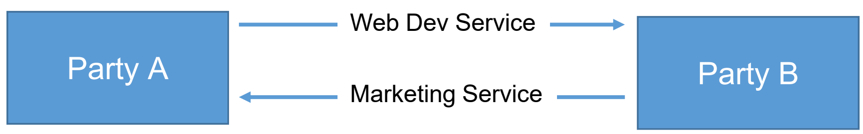
- Sales Tax: A sale is an event where goods or services are sold by a seller to the end user

Make a “Sale” vs. “Supply”

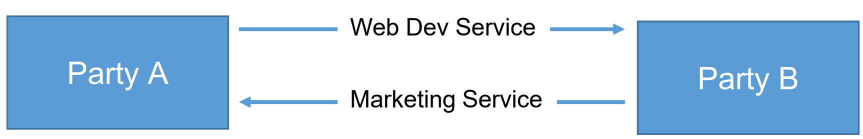
- VAT: A supply is an event where goods or services are put at the disposal by a seller to a recipient to dispose of it as owner
  - A taxable supply occurs when the seller makes a supply usually in the course of a business activity to a recipient
  - Taxable supplies are those where VAT applies
  - Note that not all supplies are taxable
  - Special case: barter

Barter and VAT

- Party A agrees to supply web development services to Party B, who in turn agrees to provide marketing services to Party A
- Parties agree that neither has to pay the other
- Services are in the framework of their business activities



Barter and VAT



- Two separate taxable transactions
- Both parties need to invoice at market value of the transactions
- Each transaction follows its own VAT treatment
- If VAT applies, VAT is due and must be paid and reported

Drop Ship vs. Triangulation

Definition:

- Three parties are involved in the sale instead of two:
  - Seller – Distributer
  - Buyer – Consumer
  - Shipper – Manufacturer
- In both cases, the goods flow from a shipper to the buyer without passing through the hands of the person making the sale or retailer

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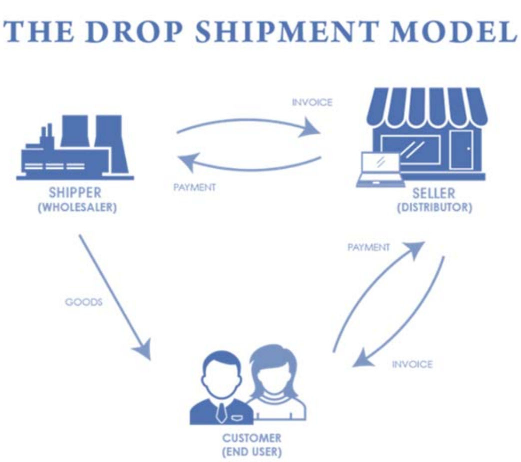
Drop Ship vs. Triangulation



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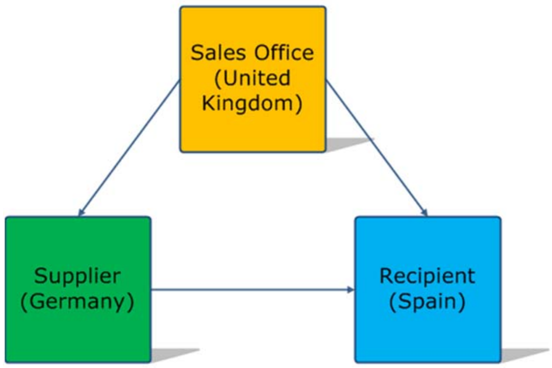
Drop Ship vs. Triangulation

- Sales Tax: Registration of parties frequently determines liability
  - If the Seller and Shipper are both registered to collect sales tax at the Buyer location then the tax is collected and remitted by the Seller
  - If the Shipper is registered to collect sales tax at the Buyer location but the Seller is not registered then the transaction should qualify as a resale transaction and a resale exemption certificate must be provided by the Seller to the Shipper
    - Exemption certificates or alternate documentation must meet the requirements of the state
    - Some states, like CA, require sales tax to be collected in this example
      - Shipper collects the tax from the Seller and it cannot be passed on to the Buyer

Drop Ship vs. Triangulation

- VAT: Triangulation Simplification is a term used only in the European Union VAT system
- Triangulation rules apply to Business to Business Transactions

Triangulation Simplification



In this example the UK sales office has received an order from a customer in Spain and has contacted the supplier in Germany to ship the goods directly to the Spanish recipient

Triangulation Simplification

- This situation gives rise to the following events:
  - For the supplier in Germany, an intra-community dispatch
  - For the sales office in the UK, an obligation to register for VAT in Spain
  - For the customer in Spain, a normal domestic sale
- The simplification mechanism exists so that the UK sales office will not be required to register for VAT in Spain
- Customer pays the VAT in their country and no tax is collected by the seller or the shipper

Triangulation Simplification

- Each member state has different requirements for the intermediate supplier to qualify. However these main points can be stated
  - Intermediate supplier is registered for VAT in the European Union
  - Intermediate supplier is not registered or required to be registered in the member state of the customer
  - Customer is registered for VAT in the delivery location
- If these conditions are met then the Germany supplier makes an intra-community dispatch, the Spanish customer has an intra-community acquisition and the
  UK sales office does not have to register, but he does have to issue a VAT invoice noting the simplification

Triangulation

- For Business to Consumer Triangulation
  - If Seller is not registered in Buyer country, charge Seller VAT as a distance sale
  - Seller may be required to register if exceed sales threshold into the Buyer country
- For Non EU triangulation the rules can differ and will be very dependent on the location of the parties and where they are registered

Use Tax vs. Reverse Charge

- Sales Tax: Use Tax acts as a complement to the sales tax. While sales tax is assessed upon the retail sale of tangible personal property, the use tax is generally assessed upon the storage, use, or consumption of tangible personal property purchased at retail and upon which no sales tax was paid.
  - Paid after the sale
  - The practical effect of the use tax is the assessment of the tax upon purchases made from out-of-state retailers for use, storage or consumption in the taxing state
  - Another example: item taken out of inventory and used by the business

Use Tax vs. Reverse Charge

- VAT: In a reverse charge, the supplier no longer collects the tax and the requirement to collect and remit the tax shifts to the purchaser. Most common in the EU for services and intra-EU acquisition of goods
  - The purchaser accounts for both the input tax and the output tax
  - Example: A business in the EU receives services from a different member state
  - Some jurisdictions outside the EU only have reverse charge for specific industries
  - Normally, goods brought into a different country from overseas are not subject to reverse charge, but rather, VAT is collected by customs upon importation

Reverse Charge: Example

SELLER INVOICE	base	Tax on invoice	Invoice total
(1) Sale with liability for seller to pay VAT	100	20	120
(2) Sale subject to reverse charge	100	0	100

seller → Sale @ 100 → customer

SELLER ACCOUNTING	Customer receivable	Revenue P&L	BS VAT payable
(1) Sale with liability for seller to pay VAT	120	100	20 (*)
(2) Sale subject to reverse charge			

CUSTOMER ACCOUNTING	Vendor payable	P&L expense	BS VAT payable	BS VAT receivable
(1) Purchase with liability for seller to pay VAT	120	100		20 (*)
(2) Purchase with reverse charge				

BS offset

(*) cleared through payment/refund of VAT or compensation in VAT return

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Administrative Differences

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Registration Requirements

- Sales Tax: In the US, a seller is required to register to collect and remit sales tax when they have nexus with the state
  - If a seller has sufficient nexus with the state, it is deemed to be "doing business" in that state and will be liable for the state taxes
  - With the changes to economic nexus rules, this include foreign sellers that exceed the sales thresholds
    - Most states have a threshold of $100,000 or 200 transactions in a calendar year

Registration Requirements

- VAT: In many jurisdictions, a supplier is required to register to collect and remit VAT when they exceed
  a certain threshold
  - These thresholds can vary from as low as $30,000 in Canada to as high as S$ 1,000,000 ($800,000) in Singapore
  - Non-resident businesses can also be required to register for VAT
  - In many jurisdictions non-resident businesses register with a single tax office

VAT: Requirements for Residents

- Businesses that are residents in a jurisdiction could be obliged to reverse charge on transactions made by non-resident but registered businesses in VAT systems

VAT: Requirements for Non-Residents

- Non residents can have permanent establishments
- Non resident businesses can have more onerous requirements for VAT registration
- They could have more complex filing requirements
- They could have to appoint an agent for VAT filings

Invoicing: Sales Tax

- Proper Invoicing
  - Generally in the US, sales tax must be separately stated on the invoice
  - There is no labeling or format required
  - Registration numbers are not required on the invoices
  - Consumers Use tax when applicable on service providers or contractors can not be passed on as a separate tax line

Invoicing: VAT

- Proper Invoicing
  - Generally, in the EU, the taxpayer can only claim input credits for those purchases where it can produce an invoice that is in line with the formal requirements like e.g.
    - showing the amount of VAT paid
    - Having VAT ID numbers of seller and purchaser on the invoice
    - For some transactions in EU countries, a specific message on the sales invoice is required
    - Ex: Special messaging for exports and zero-rated supplies
  - Pricing can be tax inclusive but then VAT is not deductible

Compliance & Remittance

- Sales Tax: Registered taxpayers must collect and remit sales tax
  - The worst thing you can do is collect it and not remit it. Taxpayers hold state funds in trust and can go to jail for not remitting.
  - Taxpayers may have different reporting frequencies assigned by the jurisdictions (monthly/quarterly/semi-annual/annual)
  - Various filing methods (paper/telephone/electronic) and payment methods (cash/check/EFT) are used depending on the jurisdiction requirements

Compliance & Remittance

- VAT: Compliance requirements vary widely between jurisdictions
  - Some jurisdictions have simple VAT returns that only require information about total VAT collected and paid
  - Others require detailed breakdowns by rate and type of transaction
  - All European Union member states require separate filings for sales lists and recapitulative statements which could have different filing frequencies than VAT filing
  - INTRASTAT filings which are statistical reports for intra EU transactions – require additional data often not in financial systems
  - Need to file and remit in local country currency
  - Records may need to be in local language

Compliance & Remittance

- VAT: Compliance requirements vary widely between jurisdictions
  - Recent trend towards electronic filing in XML format (SAF-T, SII,...)
  - Importance of compliant VAT ledgers
- Increasing exchange of information between countries

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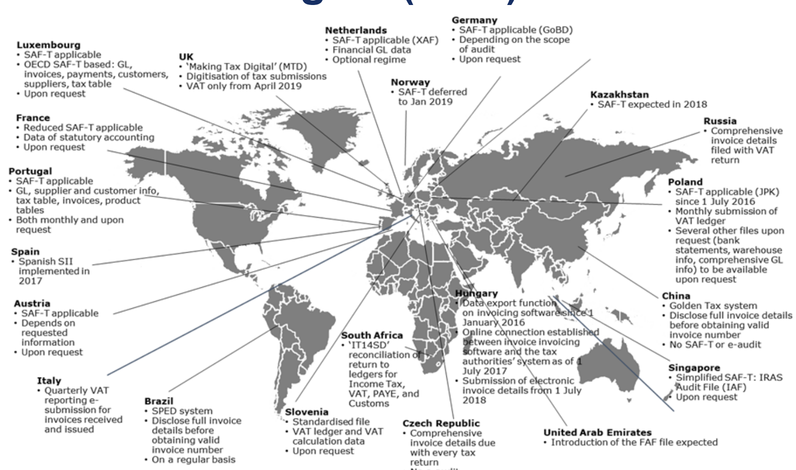
Move Towards Digital (near) Real Time Reporting



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Audit Process

- Sales Tax: Typical Audit Steps
  - Initial Contact
    - Phone, Letter
  - Appointment
    - Taxpayer’s place of business, Tax Authority office
  - Field Work
    - Reviewing records
  - Exit Meeting
    - Preliminary findings, Draft audit reports
  - Submission of Audit
    - Supervisor conference
  - Appeal Options

Audit Process

- VAT
  - Physical vs. online audits: momentum is shifting towards e-auditing, whether via invoices or via comprehensive declarations
  - Audits via government-approved invoices include China, Brazil, Taiwan
  - Country-specific declarations (e.g., VAT Ledgers, SAF-T) include several European countries
  - Exchange of information between countries : audits are triggered through cross-country mismatches
  - VIES exchange in EU
  - Real Time compliance requirements (e.g., SII): the wave of the future?

Polling Question #4

- What is your level of knowledge about VAT?

1. Worse than before this session
2. I feel I know a little more
3. I'm going to go out there and totally kill it

Questions?

Contact

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