

# *Shifting the balance*

From direct to indirect taxes

*Updates from key  
territories and regions  
worldwide on the  
development of indirect  
taxes and in particular  
VAT/GST regimes.*





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## *Introduction*





## VAT/GST systems now exist in 156 countries around the world, with seven more considering implementation by 2013.

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### ***Shifting the Balance***

In the first edition of *Shifting the Balance*, published in June 2007 we highlighted trends that are, if anything, more pronounced today. At PwC<sup>1</sup>, we see an increasing number of countries around the world adopting or reforming their VAT or GST systems in line with the demands of a rapidly changing global economy.

VAT systems (including GST) have now been implemented in 156 countries around the world, with seven more considering implementation by 2013. The trend away from direct forms of taxation and towards indirect taxes continues inexorably.

China and India have both signalled their intention to move towards a uniform VAT system to replace current regimes. The countries of the Gulf Cooperation Council (GCC) are working towards a VAT system.

As countries reform and implement their indirect tax systems, they need to confront a number of challenges. And we see some significant programmes of reform arising in response to these. Notably, the European Union has embarked on a 'once in a lifetime' consultation on reform of the VAT system, in order to develop recommendations for a simpler and easier to administer value added tax system within what are now 27 Member States of the EU. The issues that this programme of consultation seeks to address are relevant to all countries that are looking to create efficient, balanced and effective indirect tax systems.

<sup>1</sup> 'PwC' refers to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL), or, as the context requires, individual member firms of the PwC network.

## *‘Soaring budget deficits have put pressure on many governments, particularly in Europe’*

### ***Responding to the financial crisis***

Since the first edition of this publication, back in 2007, one event has dominated headlines and captured the attention of all governments around the world, namely the financial crisis. Soaring budget deficits have put pressure on many governments, particularly in Europe, to ensure that they can raise additional revenues. As a condition of receiving loans, Greece was expected to reduce its budget deficit considerably by 2014. Reducing its sizeable VAT gap is likely to be an important factor in achieving this<sup>2</sup>. And Greece is not alone. All countries face the need to improve their tax receipts, and increasingly they are turning to indirect taxes as the solution.

### ***A VAT system past its sell-by date?***

Europe’s challenge in reforming VAT largely stems from the fact that the basis of the system in place today was created in the late 1960s. At that point the EU comprised of six Member States compared to the present 27. Global trade has exploded in the intervening 40 or so years. We now operate in economies that are increasingly oriented to services rather than simply trade in goods. And the profound changes introduced by the Internet are radically reshaping many aspects of the global economy. All of these significant developments mean that a VAT system, separately administered in 27 Member States, with numerous exemptions and multiple rates applied according to national priorities, is adding to the burden on taxpayers to comply, embedding inefficiencies in collection and administration and contributing to a VAT gap between theoretical full compliance and the amount that governments are able to collect.

<sup>2</sup> See ‘Eurozone agrees €110bn Greece loans’ by Kerin Hope, Nikki Tait and Quentin Peel, published on FT.com: May 2 2010.



**Figure 1**

The objectives for the EU Commission's consultation: a simpler, more robust and efficient VAT system

<b>Technical VAT design</b>	<b>Reducing 'red tape'</b>	<b>Efficiency of collection</b>	<b>Legal Process</b>
<b>Objectives:</b> <ul style="list-style-type: none"> <li>• evolution to a 'broad based VAT system</li> <li>• complexity, uncertainty and inefficiency of the current system vs. 'best practice' VAT design that balances the interests of the government, businesses and citizens.</li> </ul>	<b>Objectives:</b> <ul style="list-style-type: none"> <li>• reduction of administrative burdens;</li> <li>• simplification: <ul style="list-style-type: none"> <li>– one stop shop (B2C); and</li> <li>– intra-group cross border;</li> </ul> </li> <li>• synergies with other legislations</li> </ul>	<b>Objectives:</b> <ul style="list-style-type: none"> <li>• improving and simplifying the collection of VAT and administration;</li> <li>• reduce the VAT gap and combat fraud;</li> <li>• protect <i>bona fide</i> traders against VAT fraud.</li> </ul>	<b>Objectives:</b> <ul style="list-style-type: none"> <li>• consultation with shareholder;</li> <li>• harmonised implementation;</li> <li>• create certainty.</li> </ul>

Member States show significant differences in the efficiency with which VAT is collected. Interpretations in individual Member States are subject to costly and lengthy legal challenges. As a taxpayer it is difficult to achieve certainty and to have access to the European Court of Justice. The VAT Gap is substantial in some EU Member States. Businesses are taking on ever more complex burdens to administer the tax. The EU Green Paper's broad remit therefore asks questions in four key dimensions around the whole range of issues associated with VAT. There are questions about:

- The technical development of the VAT, e.g. should the tax be broader based?
- Considerations of the cost of compliance
- The efficiency of collection models and the need to improve and harmonise auditing methodologies; and
- The related legal process and system.

### **A holistic approach needed**

These issues are of course inter-related. Addressing them separately will not deliver the overall improvements that the fundamental questions asked in the Green Paper are seeking to deliver. What the EU arguably needs in order to do this is a long-term strategic plan – a vision for the development of a best practice EU VAT system against which the current system can be benchmarked. Based on that, a plan to deliver on the vision of achieving greater efficiency, less leakage, simpler compliance should be articulated and implemented. So what would such a vision look like?

First of all, in developing its vision, the EU should take inspiration from best practice VAT/GST systems from non-EU countries, as well as good practices that have been developed to administer the tax efficiently within the EU.

Any vision of a modern, efficient VAT system for the EU would have to acknowledge that Europe needs to operate with a single legal system relating to VAT. This would be framed in a Regulation rather than a Directive, so that it doesn't need to be implemented in the laws of 27 separate Member States, and to provide direct access to the European Court of Justice for taxpayers.

There would be a European VAT Registration, one set of compliance rules and a single EU VAT return, to drive efficiency. This is in marked contrast with today, where we see significant variations in compliance processes.

There would be a single EU VAT Administration, with a single audit methodology, using e-auditing techniques, assessing business controls and systems in place. Therefore efforts would be focused more effectively on businesses that may not be willing to comply voluntarily. These efficiencies are only possible as a single system rather than if they were to be implemented and managed separately in 27 countries.

This vision meets the requirements of businesses in its simplicity and ease of compliance. Through automation it reduces the cost of administration and focuses on systems, controls and processes for more targeted and risk-based approaches to audit and compliance, to help reduce the VAT GAP.

Of course this vision cannot become a reality overnight, but broadly accepting its conclusions should allow all stakeholders responding to the Green Paper to begin to see that along the way to its realisation, there are undoubtedly 'quick wins' that could be implemented sooner. For example, in 2013 VAT invoicing rules will come into force that will harmonise requirements across the EU, with real benefits for taxpayers and tax authorities alike. As an immediate action the definition of the 'business control' requirement should be defined at an EU level prior to 1 January 2013.



### *Environmental Taxes*

As countries of the world continue to work out how to tackle the problems of climate change, reducing natural resources, and energy security, the role of economic instruments is becoming of increasing importance to fiscal authorities, both as a means of changing behaviour, but also as a means of raising substantial revenues from a broad group of taxpayers. Recent developments have seen the introduction or suggestion of carbon taxes in a number of countries including the UK, Ireland and China. Meanwhile, a draft revision of the EU Energy Tax Directive is expected imminently. This pricing of externalities represents a real cost, which business either has to pass on or bear, effectively making it a cost of their shareholders. Whilst the main focus, currently, is on carbon, there is no doubt that further taxes on other environmental resources will appear, with water, no doubt, high on everyone's list.



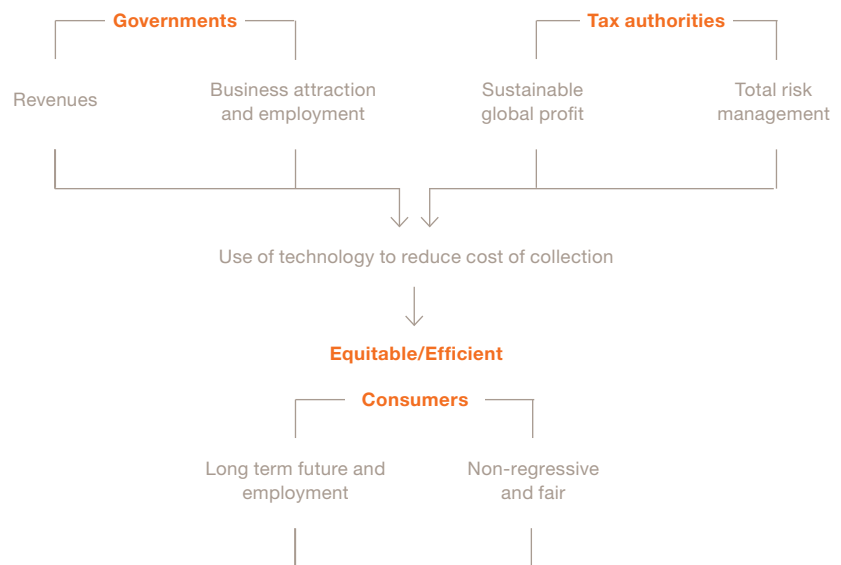
## A fair tax

Administration is, of course, only one element of reform. Developing a best practice VAT requires a number of other more contentious changes. The first of these is a broadening of the taxable base. Today, in Europe, VAT revenues represent only 55 percent, on average, of the revenues that would, in theory, be collected if all final consumption was taxed at the standard rate<sup>3</sup>. This compares to New Zealand where VAT is levied on 100 percent of consumption. Broadening the base in Europe means abolishing exemptions. But that would also create the ability to lower the rate applied with, ideally, a single rate of European VAT. To be widely accepted by citizens, the widening of the tax base has to be seen as fair, and there are justifiable concerns that a consumption-based tax takes no account of people's ability to pay. But rather than creating the complex assortment of exemptions and multiple rates we see today to address those concerns, issues about VAT's potentially regressive nature should be addressed through other mechanisms.

Those countries that have more recently introduced a broad-based VAT/GST, have used the personal income tax schedule to compensate for the impacts of a broad-based indirect tax system, and introduced other targeted measures to compensate the GST impact on household incomes. For example, when New Zealand raised its rate of GST from 12.5 percent to 15 percent in October 2010, it also changed income taxes and personal allowances to compensate lower-income taxpayers, and introduced other targeted social measures and allowances aimed at the lowest-paid and least well-off. Also a corporate tax reduction from 30 percent to 28 percent is effective from 1 April 2011. Singapore also provides a demonstration of this approach. Its rate of GST was increased from 3 percent in 1994 to the present rate of 7 percent since its introduction. But at the same time, corporate income tax rates have nearly halved from 33 percent to 17 percent.

**Figure 2**

VAT/GST systems as 'Win-Win Taxation Model'



<sup>3</sup> Green Paper on the future of VAT– Towards a simpler, more robust and efficient VAT system, [http://ec.europa.eu/taxation\\_customs/common/consultations/tax/2010\\_11\\_future\\_vat\\_en.htm](http://ec.europa.eu/taxation_customs/common/consultations/tax/2010_11_future_vat_en.htm).

Broadening the base would also make it possible to create a much lower overall rate, and simultaneously increase collections. Those extra revenues would then be available to ensure that access to education, healthcare and so on is guaranteed to all citizens, through targeted measures. It's also possible to use a broadening of the base of indirect taxes to create other measures to enhance economic competitiveness. For example, when Germany raised its rate of VAT to 19 percent on 1 January 2007, it simultaneously lowered social security charges to employers, to decrease the cost of employment and stimulate growth.

A simplified and uniform rate also addresses other distortions that bedevil the present system and create barriers to wider economic and social goals. The ambitious vision of the 'Digital Agenda for Europe' is hampered by the persistence of different rates within the EU applying to products/services that take digital as well as physical form, e.g. books, periodicals and newspapers. A modern VAT system would remove the distortions currently in place and treat those products/services equally and would also introduce clarity where today there is considerable confusion.

### ***A bold and imaginative approach needed***

In developing the vision for a modern, sustainable VAT system for the 21st Century, all countries embarking on that journey need to ensure that they take inspiration and best practice from others who have found effective solutions to common problems. No system is perfect. However, there are clear examples emerging around the world that demonstrate the steps that may be needed to create a system of indirect tax that creates positive outcomes for governments, businesses and citizens alike. The examples that we include in this second edition of *Shifting the Balance* show how some countries are moving forward to secure a 'win-win' model for all stakeholders.

*There are clear examples emerging, around the world, that demonstrate the steps that may be needed to create a system of indirect tax that creates positive outcomes for governments, businesses and citizens alike.*

Of course there is a delicate balance to be achieved between meeting national social and economic priorities and sovereignty, and enhancing the harmonisation and therefore simplicity of a single European system. For that reason, assessing the macro-economic impacts of any envisaged major change is vital, to ensure that countries can see the benefits of undergoing such a fundamental reform both at a domestic level and also at a Single Market level, and that they 'buy into' the considerable benefits that reform offers. In the absence of a more integrated approach, which a fundamental reform would bring about, the only option open to countries is to continue to raise their rates in order to generate more revenue and address deficits. However, this is clearly not a sustainable solution in the long term.



### *Customs developments*

Key aspects of globalisation and changes to world trade are having a profound impact on customs legislation, customs and trade procedures, and the approach of the customs authorities. Some of these major changes relate to the development of greater automation in customs procedures via eCustoms, and others to the need to ensure that increasingly stringent safety and security requirements are met. In consequence, companies are now faced with new data and filing requirements. These requirements are driving them to re-evaluate their customs functions and make significant strategic and structural changes in response.

# *The changing landscape*







How has VAT/GST been implemented, or developed in three key regions of the world? We review changes seen in Central and Eastern Europe, the European Union and the Middle East, in the last 3-5 years, and take a look at how things may change in the future.

### **Central and Eastern Europe**

Since the last edition of *Shifting the Balance*, the enthusiasm and excitement generated by EU membership and rapid economic growth in the region has been replaced by an altogether more sober outlook for countries in Central and Eastern Europe. The region has suffered a severe impact from the financial crisis of 2008 and ensuing recession. What had been one of the most economically dynamic areas in the world has been hit by massive uncertainty, soaring deficits and a rapid decline in new foreign investment.

While economies in the region are beginning to show some signs of recovery, the path to economic growth remains difficult and long. Consequently, few in the region are predicting anything other than highly challenging years ahead. Levels of public debt have soared since the crisis, with some countries in the region running a budget deficit in excess of 100 percent of GDP. Governments are, naturally enough, seeking to address the woeful state of their finances with increased tax revenues. In the case of indirect taxes, a number of governments across the region have increased the rates of VAT, but on average only by increments of one to two percent. There have been no significant changes to any country's VAT rules, with most continuing to ensure their systems operate in line with their counterparts across Europe.

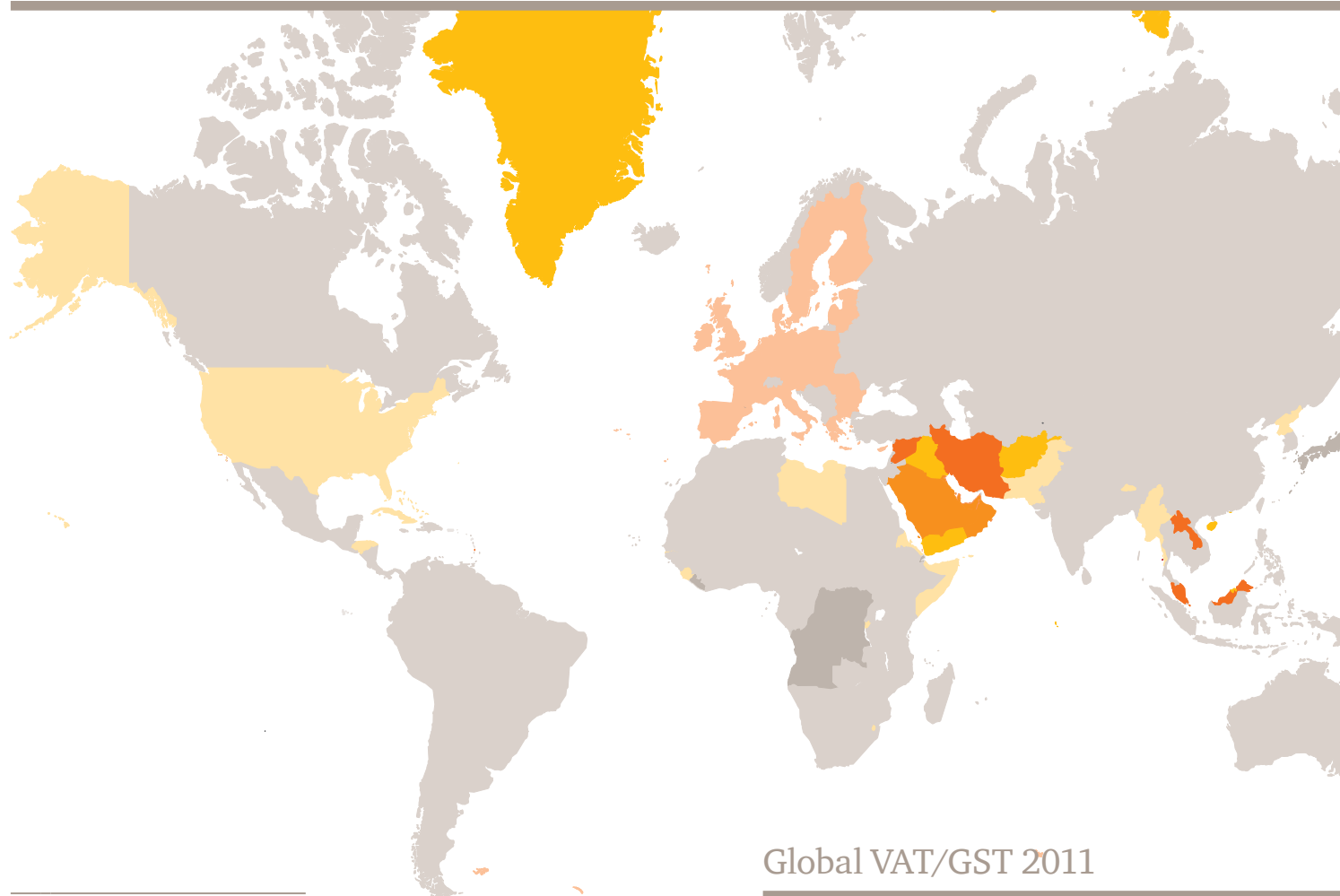
Indirect taxes continue to play a major role in State finances within the region, contributing on average approximately 50-60 percent of all tax revenues. As a critical element of government revenues, it's no surprise that governments are looking for ways to increase the tax they can generate from the consumption of goods and services. Many of the countries in the region operate with multiple rates of VAT and apply these to different items of consumption. Governments across the region face pressure to both raise rates and extend the application of VAT to categories of goods or services that have, to date, had a lower rate applied. However, political opposition to what would be perceived as regressive measures is likely to be considerable and makes large increases politically and economically unlikely, as high taxes may serve to depress already fragile demand.

Governments in the region have few choices but to focus on indirect taxes as a means of raising additional revenue. As member states of the EU, there is no leeway to increase customs duties, and increases in direct taxes such as corporate or personal tax are much more difficult than increasing indirect tax. Any increase in the aggressiveness of tax authorities in collecting VAT or disputing claims for rebates of input tax, are being met with an increased willingness by taxpayers to contest claims through the courts. In many cases, the courts have demonstrated an understanding and application of European Law and relevant rulings from the European Court of Justice (ECJ) that frequently exceeds that of the tax authorities, with the result that taxpayers have won a number of key cases across the region. However, tax authorities in the region are showing an increased willingness to discuss specific issues with taxpayers and to help resolve potential problems through engagement and negotiation.



# The world at a glance: developments in VAT/GST since 2007

## Global VAT/GST 2007



### Global VAT 2007/2011

Key (for both maps)

	Existing VAT/GST System
	General Consumption Tax
	EU VAT System
	Future VAT/GST
	Sales Tax
	No VAT/GST
	Considering a VAT System

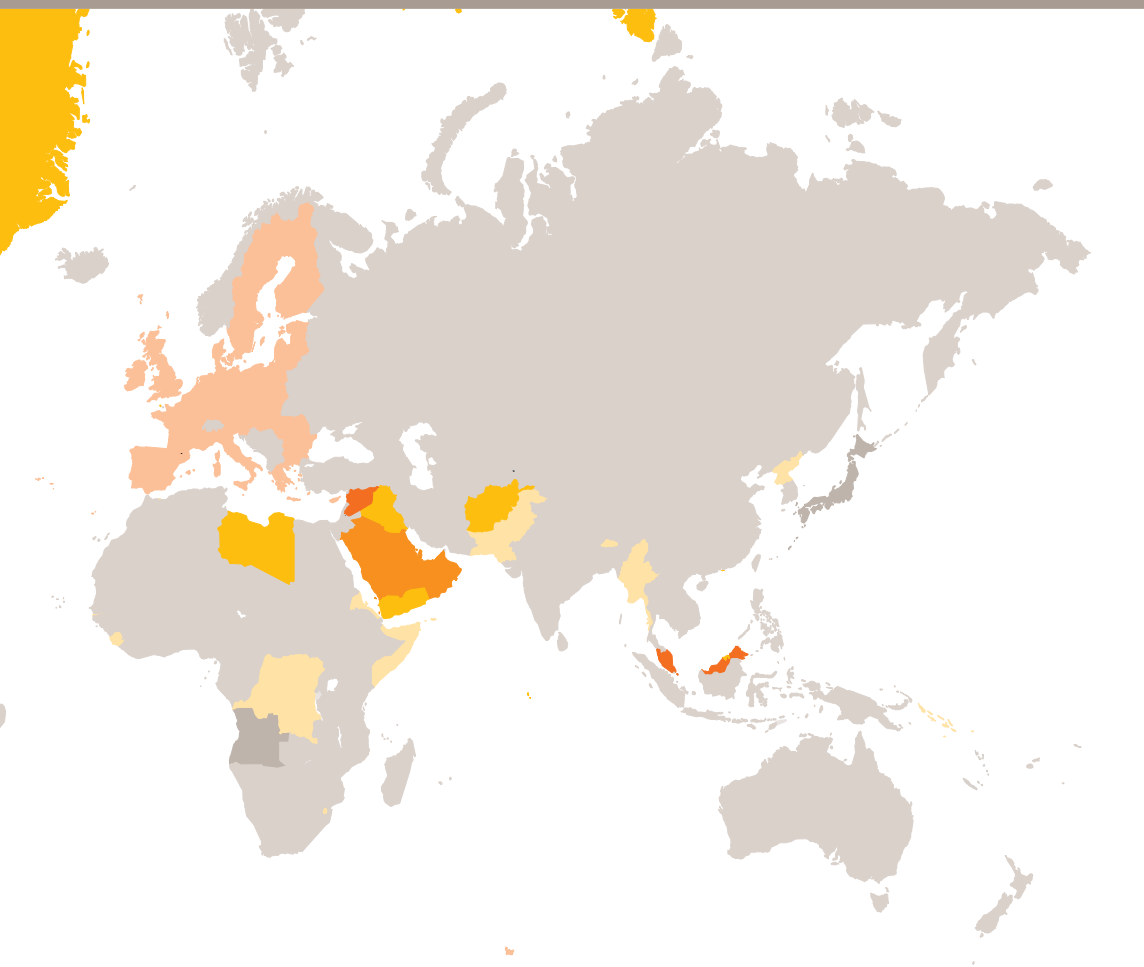
## Global VAT/GST 2011



### **European Union**

With 27 Member States now in the European Union, making significant changes to VAT is a politically fraught activity. Nevertheless, the European Commission believes that change is required and is consulting widely with taxpayers and the tax profession to build a comprehensive picture of the reforms that may be required to create greater simplicity and ease of administration, at the same time as combating fraud.

VAT fraud remains a key issue for all European Member States, and consequently it is high on the agenda for the Commission. An estimated 11 percent of VAT revenue is lost annually through fraud – principally ‘missing trader’ or ‘carousel fraud’ – which equates to in the region of €100 billion. In the absence of a European-wide solution, some Member States, for example the UK, have been allowed to introduce reverse charge mechanisms (where the buyer rather than the seller is responsible for paying VAT, for some goods and services that may be particularly susceptible to fraud (e.g. mobile phones). A more comprehensive measure, however, remains some way in the distance as it requires agreement from all 27 Member States.



The shift to a digital economy is also likely to require new mechanisms to ensure that suppliers that operate from outside the EU, but make supplies directly to consumers in EU Member States, register for, and charge, VAT. When measures were introduced five years ago to create a 'one-stop shop', whereby suppliers of digital services could register in one Member State for VAT purposes, the scale of the digital economy was less than one third of its size today. As the digital economy increases in size, the problem of enforcement will grow with it and will make it increasingly challenging for tax authorities to identify all taxpayers that should be registered for VAT.

A number of changes in recent years have been designed to reduce the complexity that businesses have had to contend with when engaging in cross-border trade. Determination of place of supply rules have been changed to reflect the complexity of reclaiming VAT for business-to-business transactions. The rules now allow businesses to reclaim VAT through a digital portal of the tax authorities, in their own jurisdiction and this has made administration much simpler and more efficient.

From 1 January 2013 there will be uniform requirements for invoicing, for all VAT registered businesses. The aim is to harmonise invoice requirements across Member States and this will be particularly beneficial for pan-European entrepreneurs who currently need to meet different conditions in different countries.

### **The Green Paper**

The consultation on VAT reform was launched in December 2010 and is due to complete at the end of May 2011.

The Green Paper has the express aim of going beyond minor modification and is instead seeking "to launch a broad-based debate with all stakeholders on the evaluation of the current VAT system and the possible ways forward, strengthening its coherence with the single market and its capacity as a revenue raiser whilst reducing the cost of compliance."

Businesses are raising a number of major issues that they believe need to be addressed to create greater simplicity, certainty and lower the cost of compliance – and are particularly focused on cross-border trade. As mentioned beforehand, combating fraud is high on the Commission's agenda, but any solution to that problem would have to ensure that it did not create additional complexity. For example, charging VAT locally to businesses in other Member States when engaged in cross-border trade has been mentioned as one possible solution, but this would require the creation of an EU-wide clearing system to manage refunds between Member States, which would be a major technical and administrative undertaking.

The Commission is arguably keen to move the EU VAT system away from the classical model and closer to a 'modern' system that is broad-based, with fewer rates and a greatly reduced number of exemptions. And while the theoretical appeal of a system like this is easy to see, the political reality of achieving unanimity among 27 Member States arguably makes realisation of that vision a very distant prospect.

### **Middle East**

With political turmoil in the region dominating headlines, it is perhaps unsurprising that the introduction of VAT or GST systems (or changes to existing systems), is not at the top of the political agenda. Nevertheless, there is no reason to believe that countries that have been working towards the introduction of such systems will not continue with their programmes – albeit at a slower pace – with those most likely to do so in the medium term including Syria and members of the GCC.

### **Syria**

Syria's Administration had suggested that it would implement VAT in 2011 but that commitment has now been deferred until 2012 at the earliest, with the Syrian Minister of Finance recently suggesting that VAT in Syria will be implemented when – and only when – the 'appropriate conditions' are met. Efforts are being made to ensure proper systems and procedures are in place, notably in terms of invoicing and automation, for a smooth VAT implementation. Syria is, at the same time, working on a more general revision of its income tax system, in line with the introduction of VAT, as well as enhancing its administrative processes through the introduction of a unified tax procedure law, which should contribute to creating the right context for introducing VAT.

### **GCC**

The countries that make up the Gulf Cooperation Council (Bahrain, Kuwait, Qatar, Saudi Arabia, Oman and the United Arab Emirates), had made a broad suggestion that they would seek to implement VAT systems by 2012/13. While this is still on the agenda, it is only the UAE that presently seems to be working on a VAT project in earnest. The UAE Federal Administration continues to work on several aspects of the project, and it remains possible that the UAE could be ready to implement VAT by 2012.

The differences in hydrocarbon reserves between GCC members mean that the urgency for non-oil related sources of government revenues is more acute in some countries than others. However it seems unlikely that any of the GCC members would introduce VAT unilaterally, without a strict and formal commitment by all GCC members to implement VAT by an agreed date.

### **Business expectations**

It seems that the trend in the region is towards having a high VAT registration threshold and consequently, only large businesses are required to comply with a VAT system. This responds to the concern of newly-created VAT administrations around managing a large number of taxpayers in comparison to the revenue generated. Lebanon for example has started with a threshold of US\$300,000 in 2002 and it has been periodically decreased to its present level of US\$100,000. However, the 2011 draft budget law proposes that they go back to a higher threshold, to facilitate a more efficient VAT administration.

Businesses in the region are not concerned with the imposition of VAT itself, seeing it as a cost that will largely be passed through to consumers and end-users of their services, but would be more concerned with the way tax administrations implement and enforce a new tax system. Businesses are keen to ensure that tax administrations operate with transparency and clarity, and that the demands of compliance are communicated effectively.

Traditionally, consultation of businesses has not been extensive in the region. There is no formal consultation process for passing any new legislation. The trend so far is to organise awareness programmes for the business community, taking an educational approach, rather than as a consultation exercise. This was the case for Lebanon where they launched an important awareness campaign in 2001. More recently, Syria seems to be following the same trend. It remains to be seen how much – if any – consultation will take place in the GCC.

*‘It’s likely that any introduction of VAT would operate with a common framework for GCC members, much as is the case in the European Union’*

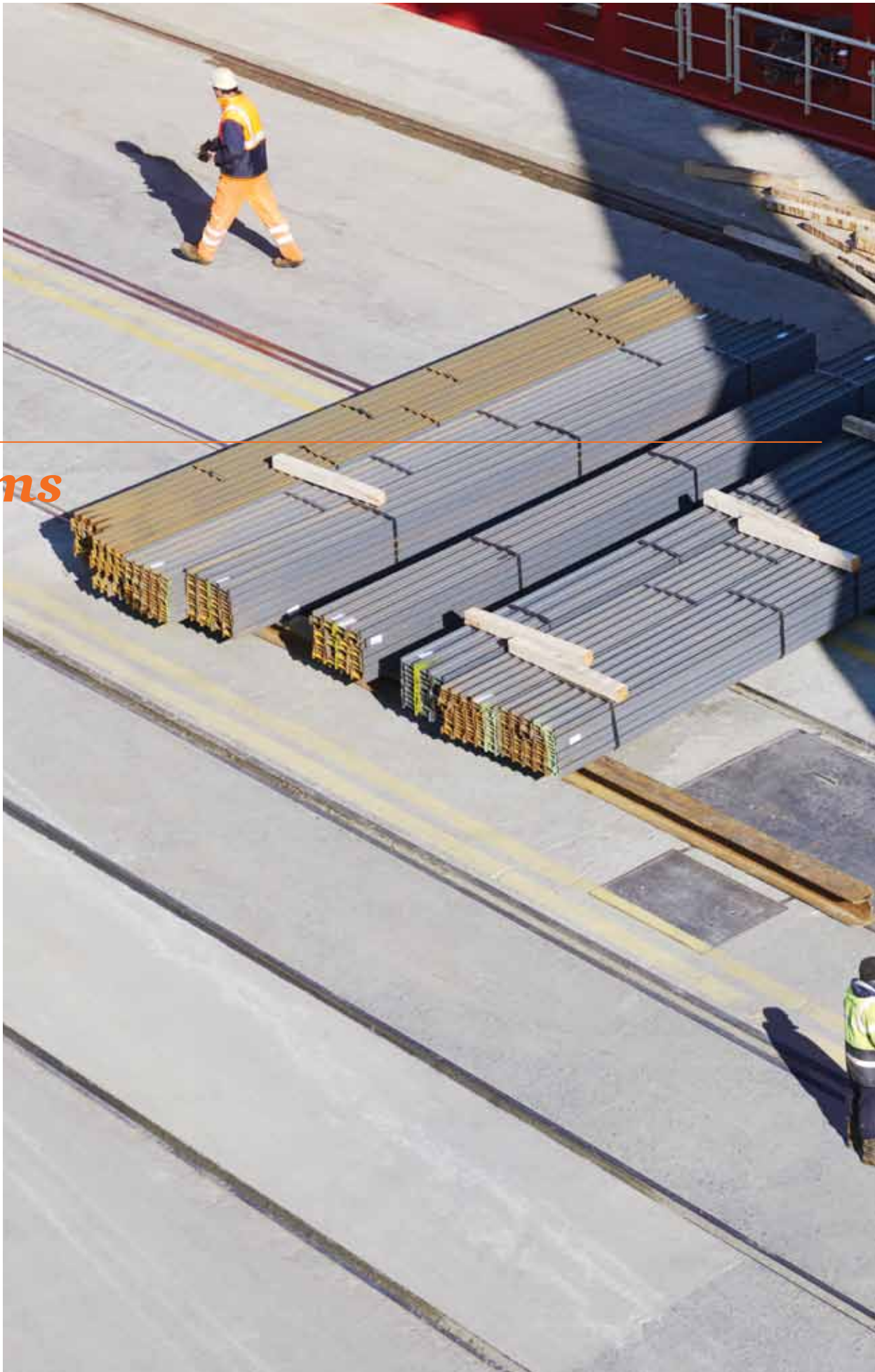
Moreover, it’s likely that any introduction of VAT would operate with a common framework for GCC members, much as is the case in the European Union, in order to facilitate intra-region trade and address any major competitive distortions that may arise between neighbouring countries.

### **Addressing regression**

Concerns about the regressive nature of a consumption tax make it a contentious subject, particularly in the tense political environment that the region is subject to. There are signs that the unpopular and politically sensitive nature of consumption-based taxes is impacting VAT-related policy-making. Lebanon, for example, has not proceeded with an expected VAT increase from 10 percent to 12 percent.

It’s also highly likely that smaller countries in the GCC will need to balance the need to raise non-oil related revenues against broad social welfare considerations. Achieving this will involve a mix of exemptions in the implementation of VAT itself, alongside other tax and social measures in order to raise VAT acceptance. The need for exemptions is clear in Syria’s proposed VAT system and that will likely come accompanied with a list of goods and services that are exempt from taxation.

# Customs







## Making international trade both more efficient and more secure is a tough balancing act.



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Making international trade both more efficient and more secure is a tough balancing act. Programmes designed to achieve both aims, such as the Authorised Economic Operators (AEO) in Europe, Japan and Korea, the 'Classified Management of Enterprises' in China and the SAOC in Argentina, to name but a few, have gained a degree of traction among businesses, but have not provided the complete solution to resolving the conundrum that, at their launch, some had perhaps hoped for.

Compliance with growing demands from customs authorities, for data on a global basis is, however, having a perhaps unanticipated consequence. Businesses are focusing greater attention on the way that their customs functions and departments operate.

A number of drivers are behind this trend and include greater awareness of the efficiencies available from taking a global approach to organising the customs function, as well as more integrated and joined-up scrutiny by tax authorities of companies' compliance across their operations. New obligations – for example with regard to security, health and safety, movements of money – and highly complex international supply chains have created the realisation that a more holistic approach to a global customs function is needed, from which new (planning) opportunities frequently become visible.

### Addressing security

A number of programmes across the globe – C-TPAT in the US, the Authorised Economic Operator programmes in the EU, Australia, Japan, Korea, Norway and Switzerland, the Secure Trade Partnership in Singapore, Partners in Compliance in Canada and the Secure Exports Scheme in New Zealand prominent among them – were put in place as a reaction to the events of 11 September 2001 and concerns over the need to combat global terrorism. It is arguable that, in practice, the expectations of what those programmes could deliver were set too high. The main differences between the programmes are that in the AEO style, the company itself is the focus of the requirements, whereas in the security style, the related supply chain is also reviewed, before a party can acquire the C-TPAT status, i.e. requiring all relevant suppliers to provide information about their security standards and processes.

Advanced data requirements resulting from new legislation (US: 10+2 / EU: pre-shipment and pre-arrival information), are an increasingly common demand from customs authorities around the world and many companies now routinely gather and file detailed information to comply with these requirements. One of the challenges that many global businesses face, however, is the lack of uniformity of the advanced data required by different countries, despite the fact that there is significant overlap between the information needed. The desire to retain sovereignty and administrative processes by each jurisdiction makes it highly unlikely that any integrated solution will be agreed. In particular, many developing nations are concerned that more onerous trade data requirements will make them less competitive in the race for foreign investment.

However, to ensure that they can eliminate as much duplication as possible in data capture processes, many global businesses are seeking to capture all relevant information in one single process, so that they have a single dataset that can be used to meet all requirements.

### E-customs

Automation of customs procedures has been a fact of life in many countries for some time and efforts to refine and improve systems are ongoing. Customs in the US, for example, has for a number of years been deploying automated systems, and today most filings in the US are electronic. Any challenges in the US therefore arise from system development rather than establishing the desirability of automation. In the European Union, a number of Member States already operate with highly automated processes and procedures. However, it is not, by and large, the technology that is impeding the development of e-customs procedures in the EU. The obstacle is the slow progress of legislation.

*‘There is little doubt that global trade has become more complex as a result of concerns about safety and security’*

While a number of companies around the world have acquired AEO status, the programme has not been widely taken up. However, the EU now as a condition to apply simplified procedures, requires a company to fulfil the requirements of the AEO, even if they do not apply for that status on an official basis. In the US, C-TPAT has seen an increasing number of businesses entering into the programme, and the US has also made this status a requirement for inclusion in other initiatives. However, the lack of mutual recognition (whereby adherence to one standard is accepted by others), between important jurisdictions is still an issue. Efforts to achieve mutual recognition between these larger trading blocks have, to date, still to be concluded. In developing countries too there are issues, as programmes are often introduced under pressure from the US or EU, but requirements for the adoption tend to be weak and their value tends to be questioned by most companies.

The political challenge of implementing a common code and application thereof across 27 Member States is also hampered by local implementation of standards and interfaces. In this respect, many businesses echo the US complaint to the World Trade Organisation (WTO) that while operating as a single customs union in theory, local implementation of procedures in the EU can add considerable cost and complexity.

ASEAN, another large Trading Bloc, has been making progress towards developing a regional single window for interactions between authorities and importers/exporters, but such progress is slow, fraught with many political obstacles and the ultimate target still falls well short of what would be an attractive proposition for multinational businesses.

Ironically, many of the least developed countries, with the help of aid programmes funded by a variety of donors, appear to be making faster and more significant progress in modernising their eCustoms capabilities. Here, however, implementation details and preferences will vary depending on the programme sponsor, once gain creating diversity where standardisation is needed.

Nevertheless, regardless of chosen standards, as more customs authorities automate and digitise their procedures and administration, they will find it increasingly easy to exchange data with their global counterparts. Global companies will need to make sure that their own customs data and information is similarly globally connected and consistent, creating significant efficiencies across a global customs function.

### **Trade facilitation**

There is little doubt that global trade has become more complex as a result of concerns about safety and security. Achieving the balance between ease of trade, and security, remains challenging. However, the proliferation of data arising from security programmes allows customs authorities to make more informed choices about what to target and will, over time, help to increase overall efficiency for legitimate operators.

Despite security concerns, there are programmes around the world aiming to deliver greater ease of trade. Much of this effort focuses on streamlining the administrative remit of different bodies responsible for particular types of goods. So for example, in Singapore, the requirements of different departments overseeing different aspects of imports, (e.g. customs, agricultural, health and so on), have been harmonised, data sharing has been enabled and duplication of processes has been eliminated. However, in many other jurisdictions, the entrenched interests of particular governments, departments, and a reluctance to cede authority, make such administrative simplification a challenging political prospect.

There are many countries, particularly in the developing world, for which Customs are a major contributor to state revenues. Consequently, their policies are likely to be determined by revenue considerations for some time to come, and only lip service may be paid to any trade facilitatory or security enhancing programme that threatens to reduce revenue intake.

### **The customs function in focus**

The focus on the customs function within businesses has increased – and it is driving changes to its organisation on a local, regional and global basis. Many companies have seen the function develop historically as part of the logistics function and this has meant it has not been subject to wider or more strategic analysis. Today that is changing, with the function receiving greater scrutiny from, and accountability to, senior management. Balancing the often widely differing expertise requirements into a smoothly operating centrally managed customs and trade department will be a key challenge.

At least businesses have woken up to the importance of the customs function and are starting to ask more probing questions about its operation, reliability and efficiency. As previously mentioned, the development of safety and security programmes around the world – and the extensive data they require – is partly responsible for this trend. In addition, the emphasis that revenue authorities worldwide place on the control and accountability of senior management has also played its part.



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# *Australia*



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Kevin O'Rourke

PwC Australia

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## As Australia's GST system approaches its 11th anniversary (coming into effect in July 2000), the 'new' indirect tax regime is beginning to display some signs of maturity.

To some extent, the degree of uncertainty associated with a relatively new tax has been addressed by some significant rulings in recent years, and a sizeable body of jurisprudence is developing. On the other hand, the responses to perceived flaws in the GST legislation, highlighted by legal challenges, have resulted in a considerable increase in new administrative provisions flowing from the Board of Taxation review, with literally hundreds of technical amendments being made. The result is that a lack of certainty is now being replaced with concerns about complexity. In the space of 12 months, GST law has expanded by 100 pages and shows little sign of slowing down in the immediate future.

For example, the Board of Taxation identified an anomaly with input tax credits for third-party payments between manufacturers and consumers, where manufacturers offer a direct discount. The approach to addressing the anomaly has been to create a new Division in the law, with numerous technical requirements, to deal specifically with what is a relatively simple and straightforward situation. There are many other similar examples. The net effect of all this activity has been that most practitioners and tax managers are finding it hard to maintain pace with the volume of change.



Aside from the launch of additional administrative measures for GST, two proposed taxes are driving significant debate in Australia. The first of these is the creation of a carbon tax. The government has recently announced that a carbon price will be set in preparation for what many expect to see as the introduction of a carbon tax. The other major new area of tax is the introduction of a 'mining tax' on one of Australia's major industrial sectors. The original proposed tax (a Resource Super Profits Tax) has been reformulated as the Mineral Resource Rent Tax.

Overall, the balance of taxes in Australia continues to shift away from direct towards indirect forms of taxation.

### **Who is taxable?**

Australia has a very broad definition of who is required to register for indirect taxes. This definition includes anyone 'carrying on an enterprise'. It is broad enough to pick up any entities that carry on an enterprise of any kind and, for example, covers all government entities at local and national level. With minor exceptions, any entity that conducts business of more than A\$75,000 of taxable supplies annually is required to register.

### **Exemptions and their impact**

Certain items are excluded from GST, including financial services and residential housing. There are also zero-rated items, the largest category of which, in dollar terms, is basic foodstuffs. In 2010 GST raised just under A\$47 billion. Had basic foodstuffs been taxed, they would have added in the region of A\$6 billion to this total. In total, approximately 57 percent of all consumption is subject to GST.

Rather than offering rebates or broad exclusions, the potentially regressive nature of GST was addressed at its inception, with a series of structural reforms to the wider tax and benefit system. The introduction of GST was accompanied by a significant amount of economic modelling to understand its likely impacts on particular economic and social groups, in order to address any of the regressive outcomes and distributional impacts that may arise from the imposition of a universal tax on consumption.

### **Who complies and how?**

With a reputation as one of the most technologically advanced tax departments in the world, the Australian Tax Office (ATO) has increased and extended its use of IT-based audits, becoming increasingly sophisticated in its approach and techniques over the last three or four years. This has driven taxpayers to respond with their own systems-based internal reviews, in order to make sure that they are keeping pace with the ATO. This growing technological sophistication is demonstrated by the ATO now, increasingly, communicating directly with large taxpayers about their specific risk rating, why they have achieved it and what they need to do to reduce it. Sending this information directly to the CEO and the Board has served to drive tax higher up the corporate agenda.

### **Consultation**

The consultation process for new legislation is extensive and open. Changes to the administration of GST, for example, have been accompanied by broad opportunities for taxpayers and their advisers to raise concerns and comment on drafts. However, despite welcoming the transparency and the opportunity to comment, the sheer volume of changes and proposed legislation has led many to identify the onset of consultation fatigue. A deluge of new legislation and amendments has meant that practitioners and professional bodies have been unable to keep up with the volume of requests for consultation taking place.

### **Addressing the gap**

While the ATO conducts extensive analysis of the gaps between the receipts from hypothetical full compliance with GST and other indirect taxes and the amounts collected in practice, data is not made publicly available.

### **Cost of collection**

The fully automated, systems-based processes that underpin the administration of GST mean that once investment has been made in the appropriate systems, the ongoing costs of compliance and collection are relatively low when compared with those associated with direct taxation. This means that GST teams within businesses tend to be smaller than in areas dealing with other taxes.

### **Shifting the balance**

The Budget Papers for 2010-11 show total tax revenues in 2010 as A\$269.5 billion, with A\$81.4 billion in indirect taxes and A\$188.1 billion in direct taxes. GST receipts were A\$46.8 billion (17.4 percent of total taxes).

Comparing that data with that available from the Budget Papers of 2007 shows that GST takes up a higher proportion of taxes, and nearly four times the dollar amount, that sales taxes raised in their final year of operation in 2000.

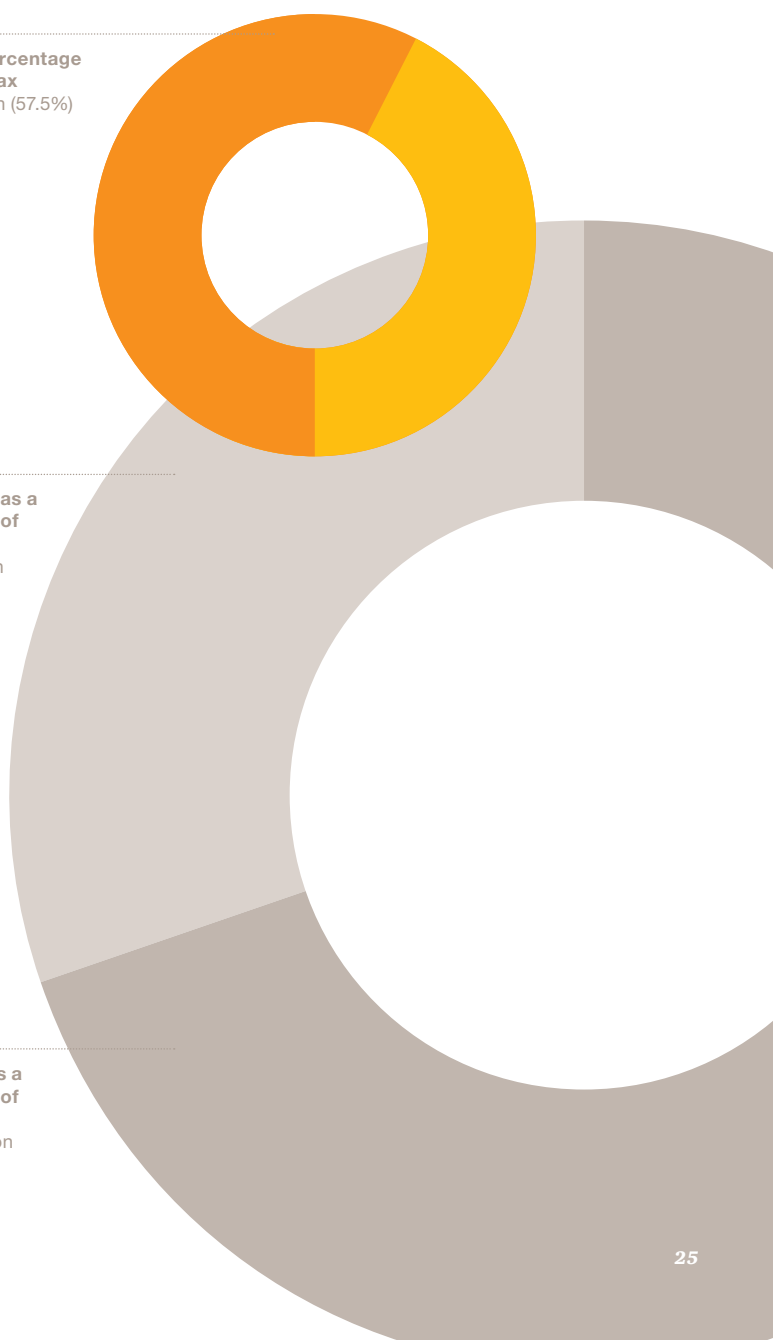
#### **Federal tax revenues**

Australia

GST as a percentage  
of indirect tax  
A\$46.8 billion (57.5%)

Indirect tax as a  
percentage of  
total taxes  
A\$81.4 billion  
(30.2%)

Direct tax as a  
percentage of  
total taxes  
A\$188.1 billion  
(69.8%)





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# *Brazil*

Celso Grazioli

PwC Brazil



## Brazil's indirect tax regime is complex and detailed, characterised by multiple rates and many exemptions.

Brazil's indirect tax system comprises four taxes, including the main state tax – ICMS (VAT) – that is levied by each state on goods and some services. The rates vary in general from 7 percent to 25 percent according to a number of factors, including destination or origin of the goods in question. There are also three federal taxes: IPI, applied on manufactured goods that operates in a similar way to an excise tax and ranges from 0 percent to 300 percent, and the Gross Revenue Taxes PIS and COFINS that are both applicable on the monthly total revenue earned by the companies.

The complexity of the Brazilian system inevitably gives rise to demands from business and other taxpayers for greater simplicity and these views are widely shared. However, while there is a clear consensus that reform is urgently needed, how that reform should be designed and enacted is subject to far less unanimity between the states and other key political stakeholders.

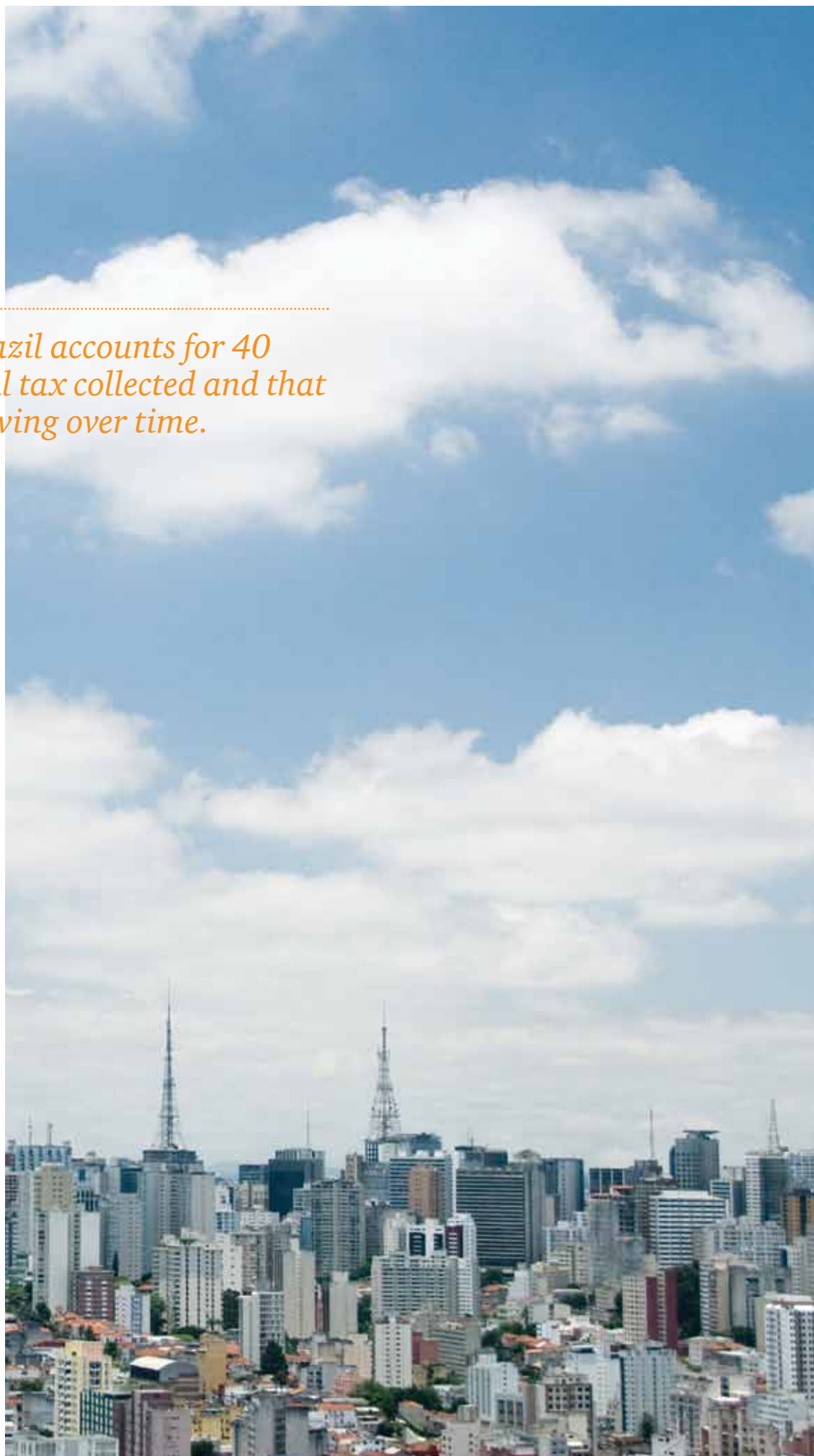
### **Definition of taxable persons**

The law defines what constitutes a taxable person. This means, in general, the definition of a taxable person is according to the requirements of each separate law. Holding companies are generally not required to register and pay for taxes unless they engage in taxable activities defined under the relevant legislation. The same concept applies to public entities.

### **Exemptions**

There are many exemptions applying across many of the taxes, and these apply at state level, which means that some goods will be exempt in some states and not in others. These depend, in turn, on a wide variety of factors and considerations, including the extent to which goods and services are seen as essential. There are also free trade zones in Brazil. This is in addition to a range of basic goods that are also exempt from many of the taxes in order to mitigate the potentially regressive nature of consumption taxes.

*Indirect tax in Brazil accounts for 40 percent of the total tax collected and that proportion is growing over time.*







### **Multiple rates**

As a locally administered tax, Brazil's ICMS (VAT) operates with multiple rates across States, according to whether goods are imported or commercialised in the internal market. The rates are set by Federal law for VAT and these are seen as necessary to drive development in different regions of Brazil. In most cases, rates vary from as high as 18 percent for transactions within States (i.e. São Paulo), to as little as 7 percent for some cross-border trade between States in the South East to North East. The rate of IPI, which is a federal tax, varies according to the extent to which goods are seen as essential or luxurious.

### **Compliance and enforcement**

Brazil operates with one of the most advanced electronic processes of VAT compliance in the world. Its Public Digital Book-keeping System, which has been in operation since 2005, covers all state and federal tax requirements with all taxpayers having to make returns and payments electronically.

The main purpose of the Digital Book-keeping System is to integrate federal and state requirements in one system, and to standardise regulatory demands across all taxing authorities. It has reduced fraud and tax evasion. Access to a common data repository allows tax authorities to inspect data in real-time, across taxpayers, and to achieve more effective audit processes, using risk-based approaches to detect possible instances of non-compliance. Having all taxpayer data available in one place has increased the number of audits overall and the tax authorities have instant access to comparisons between companies in the same sector to determine the likely averages for each industry.

The additional auditing capabilities that the advanced systems give the tax authorities in Brazil, has unquestionably increased the number of assessments. There is a clear perception among taxpayers that the tax authorities have become stricter and more aggressive.

### **Consultation**

Despite the generally accepted need for reform and simplification of Brazil's indirect tax system, there is, in practice, little in the way of direct consultation with taxpayers and the profession as to the steps that may be needed to achieve that goal.

### **VAT gap**

The complexity of Brazil's indirect tax system inevitably leads to discrepancies between theoretical full compliance and the amount that is collected. Evidence of this complexity is found in the large number of decisions and interpretations of the law that are subject to legal review.

### **The cost of collection and compliance**

Taxpayers suffer from a high cost of compliance in Brazil. Four types of indirect tax need to be separately accounted for, each with its own system of returns and procedures.

### **Shifting the balance**

Indirect tax in Brazil accounts for 40 percent of the total tax collected and that proportion is growing over time. Owing to its greater ease of collection, there is a clear emphasis on indirect taxes as a source of government revenue in the future.



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# *Canada*



Audrey Diamant

PwC Canada



## The lack of harmonisation in Canada's indirect tax regime has historically been a source of complexity for many taxpayers.

While Canada operates a federal levy – the Goods and Services Tax (GST) introduced in 1991, there are additional levies in place. These take the form of provincial-level sales taxes and other types of VAT that vary quite considerably across Canada's ten provinces.

As a result, a constantly recurring issue has been the question of if and when full harmonisation with the GST will ever be achieved. Against this backdrop, the most significant recent change to the indirect tax environment, effective 1 July 2010, saw two of the largest provinces (Ontario and British Columbia), eliminating their US-style sales and use taxes. Instead, they were replaced with provincial VAT components that were merged with the GST to create a new harmonised sales tax (HST), predominantly governed by rules established at a federal government level.

As an interim measure in both provinces, some restrictions were introduced affecting the ability to recover the provincial portion of the HST on certain expenses and business inputs by certain businesses. Taking Ontario as an example, this means that of the overall 13 percent HST payable, the 8 percent provincial component on these expenses remains unrecoverable. This has complicated the transition for many businesses.

The situation is further complicated by the fact that, amongst those provinces that do now operate HST systems, variable rates are being applied – ranging from Ontario's 13 percent to 12 percent in British Columbia and 15 percent in one Atlantic province. While it remains unclear whether or not government considers this situation to be effective, businesses undeniably find it burdensome and expensive to administer.

In the harmonised provinces, the federal government is responsible for collecting the full HST, even where there is a provincial component. These revenues are then redistributed according to an established formula. Quebec is an exception; because full harmonisation has yet to take place, the provincial government there collects its own VAT and GST.

The move towards HST includes an increased drive to reflect place of consumption (destination). Prior to harmonisation, even though the indirect tax system looked to destination with respect to a significant proportion of supplies and/or sales, scenarios still arose where some of the rules looked to location of supplier. Those 'place of supply rules' have now been largely changed to reflect place of consumption.

At an industry-specific level, there continues to be significant changes impacting companies in the financial services sector, which, in Canada are exempt from GST. The picture is certainly changing. Most recently, new legislation was introduced as part of the 2010 federal budget addressing qualification for this exemption. This has created a level of concern in the marketplace as to what qualifies as a service of financial intermediation. Clearly, some supplies remain exempt. Examples of these include full-service equity brokerage commissions paid to mutual fund dealers for the sale of mutual fund units. Others, however, have had their exemption removed, including discretionary investment management services provided to individuals, other credit and asset management services and a range of telemarketing services.

### **Developments in prospect**

Looking ahead, further upheaval and debate surrounding the tax status of financial services companies is inevitable. Where the harmonised sales tax is concerned, there has already been something of a backlash in British Columbia, with a referendum on this issue scheduled for June 2011. This will examine whether or not the province should return to the earlier status quo, with a provincial sales tax sitting alongside the GST, or whether some new form of tax should be implemented instead.

Proponents of the new regime argue that the old provincial sales tax was out of step with advances in technology and business processes and that, because it increased the cost of doing business, British Columbia was competitively disadvantaged as a result – both within Canada and on the world stage. In its favour, the new HST is widely agreed to be more efficient and, therefore, more competitive from a business perspective – even by businesses (such as financial services companies) that cannot recover the HST they pay.

Each of the provinces has introduced its own environmental levies and taxes in recent years, and more are expected as governments develop their understanding of environmental concerns and the fiscal levers that can help to address them. Additional levies have been introduced by the various non-governmental bodies tasked with addressing environmental issues, with revenues being raised to support their activities from 'stewards', for example companies that sell products with environmental impacts into provinces.

### **Who is taxable?**

Canada has a very broad definition of who is required to register for indirect taxes. Legal entities falling under the umbrella of GST and/or HST include individuals, corporations, partnerships, trusts and, in some cases, not-for-profit entities. Registration is less dependent on the nature of the entity, and more focused on the definition of commercial activity (i.e. whether or not the business is making taxable supplies). For example, if a holding company is making taxable supplies, even though it is predominantly a holding company, it may either be required to register – or have the option to register – depending on whether or not it holds shares or indebtedness in a wholly-operating entity.

### **Exemptions and their impact**

Certain items are excluded from GST/HST, including financial services, educational services, healthcare services and goods and services provided by some not-for-profit entities. These pockets of exemption, established for specific policy reasons, tend to add to the overall complexity of the rules. From a business perspective, small business thresholds apply, within which entities are not required to opt into the system. From the individual perspective, credits are provided to compensate individuals on low levels of income through transition to the Ontario and British Columbia HST systems. This is not an entirely broad base, however. Certain groceries, pharmaceutical products and medical devices, for example, are zero-rated.

### **Who complies and how?**

The tax authorities continue to make greater use of technology to assist compliance with the requirement to file regular GST/HST returns. It has also now become the norm for auditors to download significant amounts of information from taxpayers. Overall, there is a strong preference for e-auditing and other data mining techniques which accomplish a number of goals for the revenue authorities, being both more efficient and comprehensive in scope than traditional methods allow. The ability to file electronically did exist prior to 1 July 2010. However, as of that date, electronic filing has become mandatory for businesses where taxable revenues exceed C\$1.5 million – because this is a relatively low threshold, the level of electronic filing has increased substantially.

Enforcement is achieved via a combination of technology and manual processes. Where the authorities are actually on-site, the use of software to perform audits and cross-check data is standard. An additional manual level exists – where people file returns that claim refunds, a desk audit will generally be triggered automatically.

### **Consultation**

The consultation process for new legislation is extensive – at federal and provincial levels. For example, in the run up to the recent introduction of HST in Ontario and British Columbia, the government undertook broad outreach to stakeholders via conference appearances, business focus groups, dialogue with consultants and accountants and feedback from commodity and sales tax experts.

### **Addressing the gap**

It is, of course, common knowledge that there is a gap between hypothetical full compliance with GST and other indirect taxes, and the actual amounts collected, with certain industries having reputations for being particularly uncooperative. That said, levels of voluntary compliance are high and tax evasion and fraud are pursued aggressively by the CRA and severely punished, particularly so in the current economic environment. Legitimate planning that seeks to take advantage of any gaps in the legislation is a source of some tension, and the federal authorities continue to counter such efforts through retroactive legislation.

### **Cost of collection**

As a general observation, the prevalence of systems-based processes for administering GST/HST mean that, once the initial investment has been made, the ongoing costs of compliance and collection are relatively low (compared to the costs associated with direct taxation).

Various studies have examined the impact on compliance costs incurred by taxpayers in Canada of the removal of provincial retail sales taxes and their replacement by the HST. In a study for the Canadian Institute of Chartered Accountants (CICA) in 1995, Robert Plamondon, a recognised authority on Canadian tax compliance costs, estimated business compliance costs for provincial retail sales taxes to be between CAD \$400 million and \$700 million nationally<sup>4</sup>. In a subsequent study for Revenue Canada in 1999, based on interviews of businesses affected by the Atlantic provinces' harmonisation, Plamondon concluded that for the vast majority of taxpayers,<sup>5</sup> the HST resulted in no additional compliance costs compared to the GST. The removal of the provincial retail sales taxes resulted therefore in a direct saving to taxpayers of the \$400 to \$700 million of compliance costs associated with those taxes.

This data for 1995 for Canada is not inconsistent with estimates by the Governments of Ontario and British Columbia in 2009. In its budget announcing the Ontario decision to join the HST system, the Ontario Government estimated that harmonisation would save Ontario businesses more than \$500 million a year in compliance costs. Similarly, the British Columbia government estimated compliance costs savings of \$150 million per year for its business sector.

<sup>4</sup> Do The Right Thing, CICA Research Study on the National Sales Tax, by Robert Plamondon and Associates, December 1995.

<sup>5</sup> Impact of the Implementation of the HST on Business Compliance Costs, Research Study for Revenue Canada by Robert Plamondon and Associates, July 1999.





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# *China*



Alan Wu

PwC China



## China's basic indirect tax regulations are not overly complicated

China's basic indirect tax regulations are not overly complicated – with the provisional rules and detailed implementation rules covering the three main types of indirect tax (VAT, Business Tax and Consumption Tax), containing 154 articles. But over the years, there have been a large number of Circulars issued for additional clarification, and to refine and adapt the system to fast changing economic requirements.

There have been a number of significant changes in China's indirect tax regime over the last few years. On 1 January 2009, a new rule was introduced that shifted the VAT from a production to a consumption-based tax. And at the same time there have been changes introduced to the Business Tax too, shifting it from a levy applied to onshore services only, to cover instances where, if either the service recipient or the service provider is in China, that service will now be subject to tax.

A further likely change in the future will aim to eliminate the inefficiencies that are created by businesses dealing with both VAT and Business Tax. VAT is creditable and Business Tax is not, and so the tax authorities are examining the possibility of combining the two in order to eliminate the inefficiencies that arise from having the two operating in parallel. It's likely that there will be a pilot programme that will target specific selected industries that are currently Business Tax payers and examine the impact of switching them to becoming VAT payers only. The initial indications are that this programme will be launched this year with a view to understanding the impact of combining the two tax systems.

While there is no confirmed date for this programme, it's possible that there may be a gradual expansion of the scope of VAT to absorb more Business Tax payers into the VAT net, and it is arguable that we may well see the eventual abolition of Business Tax in favour of a broader-based VAT. Most businesses would, conceptually, welcome this change, as it would increase simplicity and help to eliminate inefficiencies arising from multiple layers of tax. Of course, the details of implementation will determine the ultimate reception of the proposed changes.

### **How broad is the definition of taxable persons?**

VAT applies to the importation and sale of goods, and the processing, repair and replacement of goods services. Business Tax applies to all other services and the transfer of real and intangible property. Consumption Tax began as a tax on luxury goods, but has expanded to meet environmental aims – but still only applies to a handful of items. The thresholds for triggering both VAT and Business Tax are set very low, which has the effect of catching virtually all trading entities within the tax net.

### **Exemptions and multiple rates**

There are some exemptions from VAT and Business Tax, but these are not widely available. The key areas are zero rating for exported goods. And there are refunds or exemptions available for a handful of industries that the state is keen to encourage, for example the offshore outsourcing industry that can apply for a Business Tax exemption. These policies are used as a stimulus tool as the perceived need arises.

There is no granting of incentives or benefits to address the potentially regressive nature of consumption taxes. Some foodstuffs are available at a reduced rate of 13 percent, but the vast majority of goods attract the standard rate of 17 percent.

### **Compliance**

China is seeing some movement towards the use of software and online administration of tax compliance, but it remains largely a manual process. For VAT, once a business receives a licence and applies to register for VAT, the business has to operate its invoicing processes within China's Golden Tax system.

This system was launched in 1994 and replaced the manual system where hand written invoices were issued, and all businesses still had to purchase official invoices from the Tax Bureau and deliver these every month for verification. The Golden System is an attempt to ensure that output and input taxes are effectively reconciled. Each invoice-issuing business is required to purchase a dedicated system from the Tax Bureau to create invoices. These systems record the details of the invoice onto an IC card. The data captured on that card is downloaded into the Tax Bureau's system when the taxpayer makes their monthly return. To achieve an input credit, the taxpayer used to be required to take all the physical invoices to the Tax Bureau for vetting. These can now be scanned and submitted online to the Tax Bureau for verification. Monthly filing of VAT returns remains manual to a certain extent, requiring a paper return.

Business Tax is slightly easier to administer as there is no input credit available and returns can be filed online.

### **Enforcement**

The tax authorities' tight control over the administration of VAT means that, while the need to carry out frequent or extensive additional VAT audits may not be high, these do take place from time to time. During an audit, the tax authorities will look at the details of transactions, such as the nature of the transaction, whether it should be subject to Business Tax or VAT, contracting parties, payments and receipts and timing of recognition, etc. They will also look at VAT invoice administration.

### **Consultation**

Taxpayers are now consulted more often about changes in the law and are being given more time to adjust to proposed changes. There are fewer instances of retroactive legislation than in the past. Consultation - in the form of discussion drafts - where it takes place, is focused on experts from the tax profession and academia or, if the change applies to a particular industry, the tax authorities may seek input from companies in that sector.

**VAT gap**

The largely paper-based and manual system of VAT and Business Tax processes suggests that there may be a gap between theoretical receipts from full participation and actual revenue collected, though there is no data available to measure this.

**Cost of compliance**

The process of compliance with the Golden Tax system is labour intensive and requires a number of staff to ensure that invoices are prepared properly. The system does not automatically interface with ERP systems, so larger businesses are restricted in the efficiencies they can generate. At the other end of the spectrum, smaller businesses that may not contribute significant amounts of tax have to perform the same processes as their larger counterparts and may suffer proportionately higher compliance costs as a result.

There is a clear understanding that greater automation would be beneficial to most taxpayers, but creating a nationwide system in one of the largest and most diverse nations in the world presents major challenges.

**Regional redistribution**

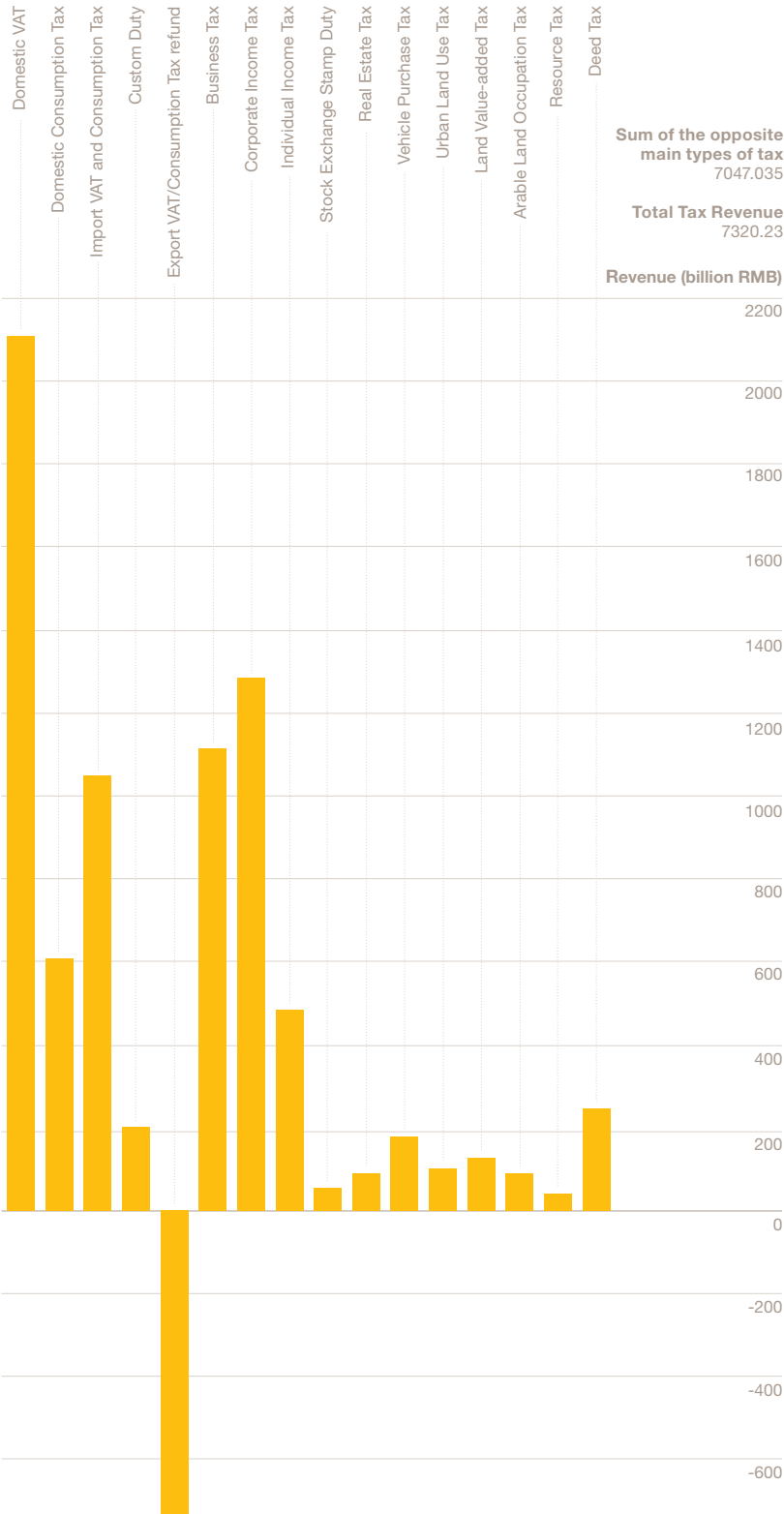
VAT is a state tax, but 25 percent of the amount collected is redistributed locally so there is a strong incentive for local Tax Bureaus to collect as much as possible. Business Tax is a 100 percent local tax.

**Shifting the Balance**

From 1 January 2008, China’s corporate income tax rate was reduced from 33 percent to 25 percent. With VAT and Business Tax rates remaining the same, there is a clear shift towards indirect taxes as a source of revenue.

**Composition of tax revenue**

China





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# *India*





Vivek Mishra

PwC India



## The largest impending change to the Indian system of indirect taxation, namely the introduction of GST, continues to be pushed back by the Indian government.

Mentioning the introduction of GST may have seasoned observers of India's tax system stifling a yawn. The firm commitment to introduce GST in April 2010 and subsequent delay was followed by an equally firm commitment for its launch in the same month in 2011, which has now also been deferred, with the Indian government taking a more tentative approach to communicating progress.

However, it would be unwise for businesses to take the twice-deferred introduction as a sign that they can forget GST in India. The draft GST law will be published this year, and that could raise a number of challenges for businesses in India – particularly those in highly competitive sectors such as FMCG – as they begin to prepare for the change. The implications go far beyond administrative concerns.

Supply chains that are presently tax-efficient may well no longer afford the same efficiencies under the new GST regime. But making significant changes to supply chains – the location of warehouses for example – is likely to be costly and time consuming. Against the backdrop of continuing uncertainty about the date of introduction of GST, businesses have to grapple with the question of timing. If they make the necessary changes in procurement, supply chain, pricing and so on too early, and GST is deferred, they would have to unwind many of the changes they have made, or lose money each day until GST is implemented. However, if they are not prepared, counting on at least one more deferment of GST, and it doesn't happen, they would be caught unawares. So the questions businesses need to start asking now is how and when they should prepare. Timing is going to be critical.

As certainly the single largest tax reform (and possibly the largest legal reform) of the last 50 years in India, the move to introduce GST is an extremely complex proposition, and this complexity explains the delay in its introduction. However, business broadly favours the move and, as the tax will be introduced as a two-tier system (operating at both State and national levels), there is widespread political support for GST (although fierce political opposition on virtually every aspect when we get to the specifics). So all taxpayers should start to consider their response to the changes, as these will be material and far-reaching.

### **Who is taxable?**

India operates three main forms of indirect tax: VAT, a service tax and excise tax. The definition of taxable persons in India is extremely broad, applying not only to individuals and companies, but also to unincorporated joint ventures, known as “associations of persons” in which two or more individuals or companies undertake business together and – subject to meeting the relevant thresholds – are required separately to register and pay taxes.

### **Exemptions and their impact**

The available exemptions from VAT in India operate on two distinct levels. The first is the exemption applied to certain goods that are most closely associated with providing basic welfare to the poorest. These include various drugs and pharmaceuticals, food grains, some forms of fuel, milk and so on. While there is little in the way of concrete data to test the efficacy of these exemptions, anecdotal evidence suggests that they are perceived to be helpful in achieving welfare goals.

The second area of exemptions applies to the VAT holidays offered by individual States to potential large investors. In 1998/9 all of India's States signed a contract with the national government that created disincentives to offer sales tax holidays to inward investors. This was achieved by the national government withholding the equivalent amount of sales tax as offered by the holiday – in effect meaning that any state offering an exemption from sales tax suffered the loss of revenue twice. However, since the move to VAT, that agreement no longer applies, and tax competition between states has returned in the form of VAT holidays, with inward investors using the willingness of some states to offer a VAT holiday to make sure that all states offer them.

### **Multiple rates and their impact**

Political considerations and social concerns about the regressive nature of consumption taxes make it highly unlikely that a single rate will apply across all consumption in India. The introduction of GST will also start with different rates. Some goods will be taxed at 12 percent and others at 20 percent, with services attracting a 16 percent charge. These different rates will gradually be phased over time to a single rate of 16 percent for all goods and services, but the timescale is likely to be dictated by the extent to which India's economic development creates a broader spread of prosperity, in order to protect the poorest from the impact of additional taxes.

### **Addressing regression**

India's attempts to limit the regressive nature of VAT has, to date, focused on providing subsidies for specific commodities such as kerosene, grains and fertiliser. However, these have been seen as driving widespread corruption, with criminal gangs controlling the supply – particularly of kerosene – and taking ruthless action against any official attempts to loosen their grip. While accurate data is hard to come by, it's estimated that as little as 25 percent of government assistance to the poor may, in fact, find its way to the intended beneficiaries.

Consequently, the Indian government now intends to experiment with direct cash payments to the poor and withdraw subsidies to the suppliers of certain essential goods. Direct cash payments will be made possible through the introduction of unique identifying number (UID) for every individual. These will, in turn, enable each person to open a bank account – even for those in rural areas. Individuals that are entitled to receive cash payments will be able to use them to buy the previously subsidised commodities directly, cutting out the incentives for corruption created by the present system.

### **Who complies and how?**

VAT is levied by each state on the sale of goods, excise duty is levied by the central government on the manufacture of goods, and service tax is also levied from the centre on the supply of services. The threshold for registration for each of these taxes is set relatively low, so only the smallest businesses are not required to register. States receive a proportion of the taxes levied and collected centrally, at a level determined by the Finance Commission – a body set up under India's Constitution. In general, there are two forms of administration – manual and electronic – and the requirement to administer the tax in one way or another is largely determined by the size of business. Most states have moved to mandatory electronic filing of returns and direct payment for VAT, though some still operate with manual processes. At the centre, all returns and payments for businesses of any material scale, are managed electronically.

### **Enforcement**

While administration is handled electronically, most enforcement activity remains manual, with investigations and audits carried out through an inspection regime. Availability of data and a lack of the appropriate systems for risk-based and analytic techniques, limit the present scope for electronic auditing techniques. The move to GST, however, will introduce greater and more accurate data gathering. This will enable a more sophisticated approach to IT-driven audit and a risk-based approach to identifying anomalies in returns and patterns of payment.

### **Consultation**

The Indian government now routinely publishes draft laws and changes on its website and invites comments from stakeholders through the appropriate channels. Changes enacted at state level are less likely to be published in this way, though the influence of the internet will also inevitably increase the extent to which changes are more broadly communicated.

### **Addressing the gap**

While there is considerable concern in India about the difference between the size of the official and the 'real' economies, actions to address any discrepancy between the amounts that should be collected in indirect taxes and the amounts actually flowing into the exchequer are at a very low level of priority. Direct taxation is likely to account for a far higher proportion of 'missing' revenue, and with some estimates claiming India's shadow economy to be 50 percent of its official counterpart, other areas are of more pressing concern.

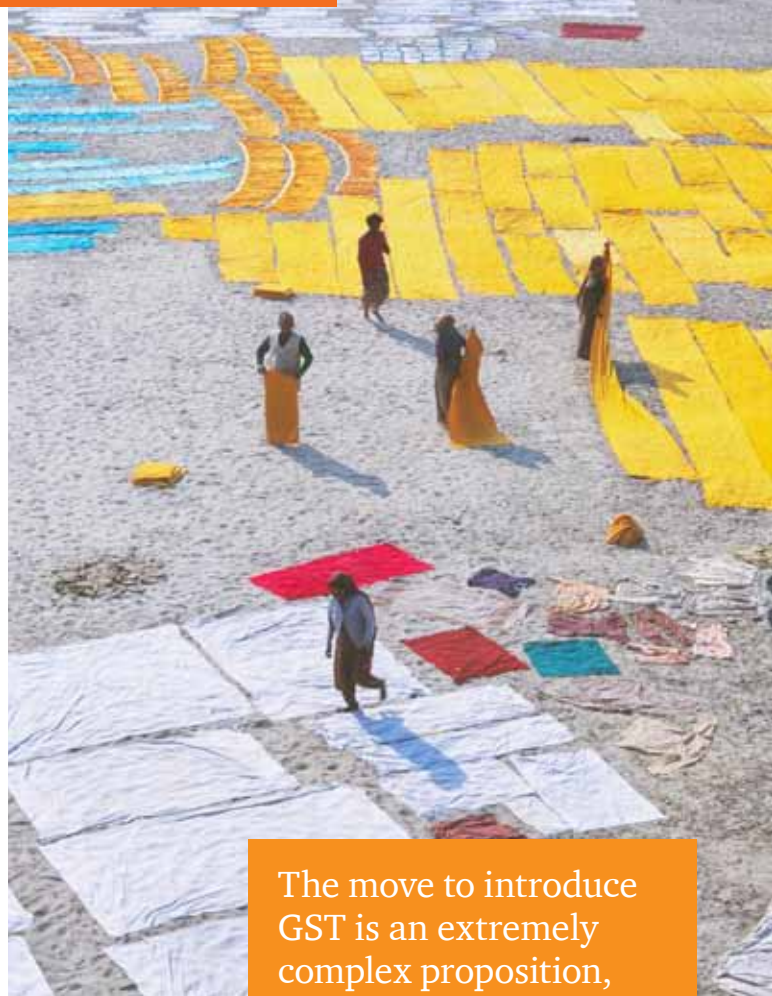
### **The cost of collection**

Data has been collated on the cost of collection in India of direct taxes. This was estimated at 0.66 percent of the revenue realised in 2009. Indirect taxes are levied and collected partly by the Central Government and partly by the states. Therefore, there has not been any data collated on the cost of collection of indirect taxes. However, sources have indicated that in their opinion, the cost of collection of indirect taxes is lower than the cost of direct taxes. That would indicate that it is less than the 0.66 percent applicable in case of direct taxes.

### **Shift to direct taxes**

In the Indian fiscal year 2006-7 (India follows a fiscal year ending 31 March), the overall Tax/GDP ratio was 11.10 percent. Of this, direct taxes contributed 5.50 percent and indirect taxes contributed 5.60 percent. In the year ended 31 March 2011, as per the budget estimates, the Tax/GDP ratio is 10.80 percent. This consists of direct tax contributing 6.24 percent and indirect taxes contributing 4.56 percent. Therefore, the share of indirect taxes in terms of overall tax revenues has been declining over the years.

The move to introduce GST is certainly the single largest tax reform (and possibly the largest legal reform) of the last 50 years in India.



The move to introduce GST is an extremely complex proposition, and this complexity explains the delay in its introduction.



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# *Mexico*



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Ivan Jaso

PwC Mexico

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## Recent interest in Mexico's tax landscape has largely focused on the introduction of the 'flat tax' for businesses (the IETU or *Impuesto Empresarial a Tasa Unica* loosely translated as 'Flat Rate Business Tax') in 2008.

Nevertheless, VAT remains something of a political football, with parties debating the merits of applying VAT to various items, for example medicines and food. In 2010, VAT rates in Mexico were raised to 16 percent and 11 percent from the former 15 percent and 10 percent respectively, and the rates for some excise taxes to additional products were also increased.

Other areas of indirect taxation, especially environmental taxes, have been much discussed, but few concrete proposals have been put in place. Businesses remain largely reluctant to see the imposition of specific environmental taxes and have lobbied effectively against their rapid implementation.

Businesses are beginning to understand the need for more effective VAT planning and are taking a more proactive approach to ensuring that their activities and investments take indirect as well as direct tax into account. This is partially owing to a significant increase in assessments by the revenue authorities in recent years, as well as a reflection of the VAT system's maturity.



### **Definition of taxable**

Mexico has a broad definition of taxable persons that covers a wide range of companies and economic entities. However, Mexico has a significant informal economy and many of the small and medium sized enterprises that should register for and pay VAT, do not, in practice, do so.

### **Exemptions**

The situation with regards to exemptions from VAT is complicated by a number of factors that are specific to the Mexican economy. Roughly 5,000 companies operate in Mexico under the maquiladora system and account for approximately 65 percent of the country's exports. Dating back to the mid-1960s, the maquiladora system offers a range of economic incentives and tax exemptions to companies operating in dedicated zones. These were initially sited close to the US border but over time, have also spread to Mexico's interior. Rapid growth in maquiladora operations followed swiftly on the heels of the conclusion of NAFTA in 1994 – with 80+ percent annual increases in employment recorded in the five years following the successful conclusion of NAFTA negotiations.

Maquiladora companies operate under a complex system of specific exemptions to account for intra-company and supply-chain transfers – a number of which date back a considerable time. The Mexican tax authorities have recently assessed a number of these exemptions to try and prevent any abuse or the application of allowances and exemptions in cases where they should not apply. However, as a powerful lobby group, the significant influence enjoyed by the maquiladora in the Mexican economy has led to a complex interaction between legislation, implementation and the assertion of considerable economic and political influence.

Mexico's proximity to the US has driven the development of a two rate VAT system in order to protect Mexican businesses operating close to the border and potentially competing with their US equivalents. A lower rate of VAT (11 percent as opposed to the standard rate of 16 percent), applies to goods and services produced by companies in the border regions. However, the operation of a dual rate creates significant complexity (for example within enterprise resource planning systems such as SAP and Oracle), for companies with operations in different parts of Mexico. There has been renewed discussion recently about the desirability of introducing a unified rate across all States. The imposition of reduced rates of VAT for some medicines and food has also been discussed. Both suggestions face considerable political opposition and are unlikely to become a reality in the short to medium term.

### **Compliance and enforcement**

Compliance with VAT remains a largely manual process. The Mexican government and tax authorities are actively pursuing the use of greater automation and electronic data, but there has been little in the way of concrete progress to date. The tax authorities' approach is driven by a 'form-over-substance' doctrine that insists upon strict adherence to administrative rules, with any deviations, discrepancies or inconsistencies likely to trigger an assessment. Auditing remains an entirely manual process, with little progress to date in developing risk-based approaches that deploy information technology to detect patterns and anomalies in returns.

Strict application of administrative procedures is accompanied by an increasingly aggressive approach from the tax authorities. This is manifest in the substantial rise in the number of assessments being raised against taxpayers, with many of them being triggered by what are very minor deviations from administrative procedures. Contesting these claims involves taxpayers (and their advisers) in what can be lengthy procedures that can take significant time and resources to resolve. This aggressive approach is also evident in the treatment of applications for refunds, for example, that can suffer from multiple delays as a result of insignificant errors in the claims filing documents.

In the face of significant uncertainty and the large volume of assessments being raised, taxpayers are perhaps understandably keen to see greater simplicity in the system and greater clarity in the administrative procedures relating to VAT compliance. While the tax authorities appear willing to listen to the concerns raised by taxpayers, there are few signs, to date, that any practical steps are underway to address complexity and create greater simplicity and predictability in the way that VAT compliance is administered. One of the barriers to significant reform is a lack of technical expertise and benchmarking with other OECD countries.

### **Consultation**

The government and tax authorities are demonstrating a growing willingness to listen (in line with a growing sense of democracy and participation across Mexico) to taxpayers' representations on specific issues relating to VAT and its administration. While that willingness may not always result in action, there has been a perceptible shift in the degree of openness and cooperation that government authorities are extending to industry bodies and associations that represent the views of particular industries or types of taxpayer.

### **VAT gap**

While there is little in the way of official analysis of the difference between theoretical full compliance with VAT and the amount that is in fact collected, many observers believe the discrepancy to be as much as 30 percent. The informal economy is a significant and persistent challenge for Mexico, as it is in many other developing countries.

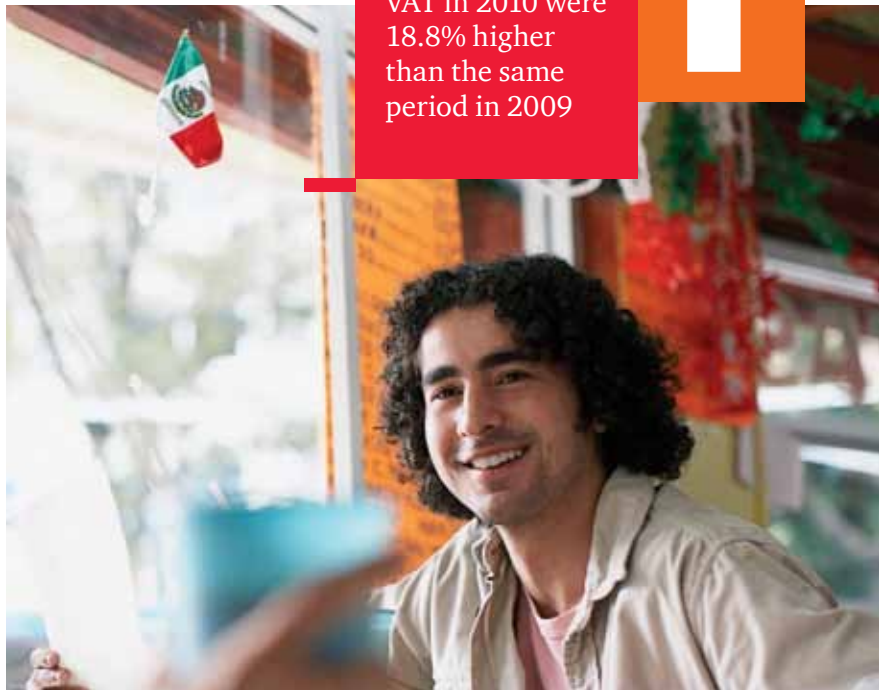
### **Shifting the balance**

Official figures from the tax office show revenues from VAT were 504,433.6 million pesos in 2010, 18.8 percent higher than in the same period in 2009. With regard to the estimate in the Revenue Act, the VAT was higher than estimated by 18,878.7 million pesos. But while VAT remains a major part of government revenues, it has not increased in proportion to other taxes. Its overall increase is due to the rise in rates.

**18.8%**



Revenues from VAT in 2010 were 18.8% higher than the same period in 2009





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# *Russia*



Vladimir Konstantinov

PwC Russia



## VAT in Russia is a significant source of revenue for the government and is considered by businesses as one of the most complex taxes to administer.

This was indicated in 2005 when business associations were consulted by the administration about possible tax simplification measures. In response, some businesses suggested the abolition of VAT as one of the best ways to achieve simplification. Of course, in the period between then and today, global economic troubles have conspired to make any suggestion of its abolition unthinkable for the authorities. Since the financial crisis in 2008, VAT is the only major tax paid by many loss-making Russian companies. It remains a major proportion of government revenue (22 percent of all tax revenues administered by the tax authorities), second only to export customs duties on hydrocarbons in its total revenue contribution.

Since 2004, Russia's main rate of VAT has lowered from 20 percent to 18 percent. Some basic goods and services attract a lower rate of 10 percent.

Recent changes in Russia's indirect tax landscape include the agreement of a customs union with Kazakhstan and Belarus that has specific measures relating to the payment and collection of VAT in transactions between the three countries.

Other developments include the imposition of a 1 percent levy of the customs or sales value on the importation or production of equipment with audio-visual capabilities. This measure was created as a means of trying to compensate IP owners from the impacts of free playback of digital films and music. While not strictly speaking a tax, in practice the levy applies broadly across a wide range of imported electronic goods and is widely perceived as an additional form of indirect taxation.

### **Who is taxable?**

Taxable persons are broadly defined under Russia's VAT system, with all legal commercial entities and individual entrepreneurs required to register for, and pay, the tax. However, smaller companies with a turnover of R60million (approximately US\$2 million) or less can opt to pay a simplified business tax that effectively combines business profits tax and VAT.

### **Exemptions**

Russia's VAT system operates with a long list of exemptions that includes a wide range of goods and services. These range from the common to the obscure, and include banking and insurance services, the sale of securities and medical services. Other items that are exempt from VAT include the licensing of software and certain types of expenditure in relation to research and development. The lease of premises to foreign entities from a qualifying list of countries is also exempt as is the importation of specific types of equipment. Some items – including certain types of food and children's clothing, are subject to a lower rate of 10 percent as a way to balance the potentially regressive nature of taxes on consumption.

### **Compliance and enforcement**

The manual and largely paper-based systems of VAT compliance that are required of all taxpayers impose a significant administrative burden. Dedicated teams are required to maintain the relevant volumes of invoices for purchases (input) and sales (output) VAT. The tax authorities often maintain a highly formalistic approach to compliance, insisting on exact adherence to regulations and may raise challenges and assessments in response to even minor deviations from prescribed processes. The emerging 'tone from the top' of the tax authorities – that is increasingly business-friendly and consultative – has yet to percolate through the organisation to the level of implementation. Here the focus remains firmly on seeking and identifying instances of non-compliance.

There are signs that Russia's system is moving towards greater automation and the exchange of electronic information between taxpayers and the authorities. Electronic invoicing is gradually being introduced and relevant provision is being made in the VAT regulations. Various notifications to the tax authorities may be sent electronically, and there is a clear desire from the tax authorities to make greater use of ICT to increase the efficiency and effectiveness of tax compliance and collection.

Russia operates as a federation with a number of federal subjects. However, VAT is collected centrally as a federal tax.

### **Consultation**

The tax authorities have established channels for consultation on new policies and amendments to the Tax Code, and business groups and associations regularly submit their views and suggestions in this way. The extent to which these views are taken into account in the formulation of tax policy remains open to question.

### **The VAT gap**

There is no specific data collected on the existence or size of any gap between theoretical full compliance with VAT and the amount collected in practice.

### **Cost of compliance**

Russia's largely manual system of VAT compliance arguably means that it is less efficient than systems in other countries that have moved more rapidly towards electronic systems. However, there is little concrete evidence, that as a manual system, it is noticeably more or less efficient and costly than comparable administrations.

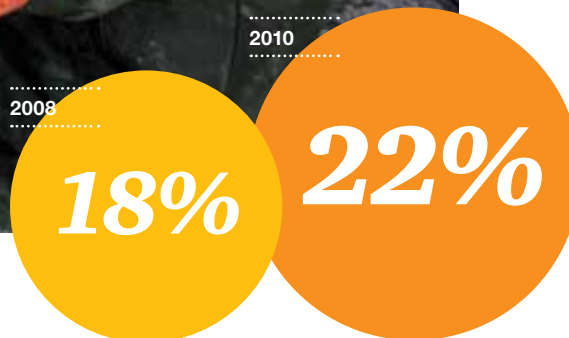






### *Shifting the balance*

The proportion of total tax revenues (administered by the tax authorities) attributable to VAT has grown substantially over the last three years, from 18 percent in 2008 to 22 percent in 2010 (2.5 trillion rubles). This increase needs to be put in the context of the impact of the economic crisis – 2009 for example saw a 50 percent decline in corporate income tax – but nonetheless demonstrates consistency with the global trend towards indirect rather than direct taxes. The largest contributor to the federal budget – customs duties – is to a significant extent, made up of export customs duty on hydrocarbons (crude oil, natural gas and oil products) that make up 87 percent of the nearly three trillion rubles generated in customs revenues.



Proportion of total tax revenue attributable to VAT



# *Singapore*



## Singapore's system of GST is broad-based, with few exemptions and a standard rate of 7 percent applied to the majority of goods and services.

In many ways it is the exemplar of a modern GST regime, and the policy of shifting reliance from direct to indirect taxation is evident in the proportion of revenues collected. GST collections have more than doubled over the last decade. With every rise in the rate of GST there is a corresponding adjustment to the corporate income tax rate, with the rate having nearly halved (from 33 percent to 17 percent) since GST was introduced in 1994.

### ***Taxable persons***

Singapore has the highest registration threshold for taxable persons in the world. This is currently set at one million Singapore dollars (US\$794,000). The definition of a taxable person is fairly broad and refers to anyone who is required to register under the GST law provided that they make taxable supplies in excess of the registration limit. This also applies to holding companies that make taxable supplies in the course of business, such as management fees and services, and for public entities that include non-regulatory supplies similar to those provided by the public sector. There is also scope for voluntary registration.

### Exemptions

The only transactions that are exempt from GST are financial services and the sale and lease of residential property. Services such as education and health and goods such as foodstuffs are treated as standard-rated supplies.

Singapore's status as a major financial centre means that it has adopted an unusual policy in offering financial institutions a very high input tax recovery rate (varying between 76 percent and 96 percent), to offset the cost of the exemption applied to financial services. This has the result that financial institutions are the lowest net contributor to GST revenues, making a 4 percent contribution in the last financial year. However, they are also the highest contributor to direct taxes.

### Multiple rates

One rate (7 percent) applies to all taxable supplies.

### Addressing perceived regression

Singapore fulfils the criteria of a modern GST, in that it is broad-based, operates with limited exemptions, and has one rate that applies to all goods and services. To address concerns about the impact on the lower income members of society, there are a number of measures in place to deal with GST's potentially regressive nature. The Singapore government uses very targeted measures, such as rebates and grants, to alleviate the burden on the least well-off. There is little economic data to gauge the efficacy of these measures, but the government does provide an annual account of the grants and subsidies that it makes available. These grants and subsidies are generally means-tested and the government also uses the income tax system to adjust assessments and effectively return income to taxpayers.

When the rate of GST was increased to the present 7 percent in 2007, the rate of corporate income tax was simultaneously reduced. When GST was introduced in 1994 the rate of corporate tax was 33 percent. Today, with GST at 7 percent, the rate of corporate tax has nearly halved to 17 percent. So there is clear evidence of a shift from reliance on direct to indirect taxes.

*Singapore's status as a major financial centre means that it has adopted an unusual policy in offering financial institutions a very high input tax recovery rate*





### **Compliance and enforcement**

GST-registered businesses are generally required to file returns on a monthly or quarterly basis, with smaller businesses being able to submit returns every six months upon application. All returns are filed electronically one month after the relevant accounting period. The payment of the tax is generally also made electronically, as are refund payments for input taxes.

The tax authorities are increasingly able to use the data received from taxpayers to carry out analysis to select businesses for audit. The tax authorities make comparisons with GST returns and income tax declarations, and search for unusual trends, as well as benchmarking between companies operating in the same sector.

Audit activity has increased in recent years, and its emphasis has also shifted. In the past, desk audits were common with the occasional field visit. Today there is a greater emphasis on systems, processes and controls to identify high-risk businesses. The Singapore tax office understands that given the scope of a broad-based GST, it is unlikely that every business will be able to pick up errors in every transaction. But with the right systems in place, businesses can identify risks of non-compliance and take appropriate remedial action. Greater availability of data and more sophisticated IT-enabled techniques are driving the development of a smarter approach by the revenue authorities.

### **Consultation**

The Singapore tax authorities take a consultative approach to the development and refining of GST rules, often making adjustments in order to provide incentives to areas of particular focus for development. For example, in the recent Budget for 2011, the bio-medical sciences industry was granted a concession enabling them to bring materials for clinical trials into the country free of GST. And this change was as a direct result of concerns raised by the industry that the imposition of GST would create a stumbling block to Singapore's ambition to becoming a bio-medical hub for the region.

### **GST gap**

Singapore's rate of compliance with the GST is very high, with the ratio of the number of businesses that are registered for GST and the filing rate generally in the region of 99 percent.

### **Cost of collection**

The Singapore tax office is remarkably efficient, achieving less than 1 percent cost of the tax collected, and this proportion has been maintained for the last several years. In general terms, businesses benefit from the tax office's efficiency with relatively low costs of compliance.

### **Shifting the balance**

Singapore is clearly moving towards a greater reliance on indirect rather than direct taxes. In the last financial year, the GST proportion of the total taxes collected by the Singapore tax authority was almost 23 percent. In 2000, GST accounted for 12.3 percent. The proportion has almost doubled in the last decade. A further indication of the shift to indirect taxes is the increase in additional taxes and penalties raised from indirect tax audits. In the most recent financial year \$154 million was collected in additional taxes and penalties from GST audits, nearly 2.5 times the amount collected from income tax (personal and corporate) audits (\$63 million).



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# *South Africa*





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Charles de Wet

PwC South Africa

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## Now in its 20th year, the VAT regime in South Africa is firmly embedded in the economy but continues to present a number of unresolved uncertainties.

In the first issue of *Shifting the Balance* (2007), our report highlighted the uncertainty that had been introduced with regards to binding rulings. The process of reviewing and renewing rulings is still incomplete, and while levels of activity have ebbed and flowed in the interim, all rulings will now have to be finalised by 1 October 2011. If they are not renewed by that date they will cease to apply. It remains to be seen how smoothly the process to renew rulings will run.

Little progress has been made with place of supply rules that were also flagged in this publication's first edition, with the debate – and the inability to provide definitive practical advice – about whether foreign IP owners should register, ongoing. Elsewhere there have been some changes. Special VAT provisions have been introduced to deal with Islamic Finance, for example. And there has been some introduction of measures to remove some small businesses from VAT altogether, with the introduction of a turnover tax. But overall there have been few specific developments in new laws. However, there has been considerable activity in issues of interpretation notes and binding class rulings for particular industries. These include, for example, clarification of the treatment of discounts and rebates for the motor and FMCG industries.

There has also been a change in the levying of interest on assessments – whereby the revenue authorities had discretion to waive interest where there had been no loss to the fiscal authorities – i.e. typically in a group company scenario. These provisions have been changed to state that the authorities will only waive interest where it is ‘beyond the control of the vendor’. What this will mean in practice remains unclear, but is likely to limit the circumstances in which interest will be waived to exceptional conditions only (e.g. the failure of a bank or a natural disaster.) With a comparatively low rate of 14 percent (unchanged since 1993), it’s likely that there may be an increase in the rate of VAT in the near future. However, there are political constraints that will apply to any increase, in light of concerns about the impact on the poorest citizens.

Some environmental taxes have been introduced on energy use, CO2 emissions from motor vehicles, and some items of consumption. But changes are largely policy-driven, rather than having a broader fiscal motivation, and the amounts of revenue in question tend to be small.

### **Definition of taxable persons**

South Africa’s definition of a taxable person - a ‘VAT vendor’ – is broad, with most active entities captured, including those in the public sector. If holding companies make taxable supplies they too need to register. The threshold for registration is one million RAND (approx US\$150,000) in turnover.

### **Exemptions**

Exported goods and services are zero-rated. Education remains an exempt supply but there are proposals to try and raise VAT on some areas of educational services. Transport by road and rail remains excluded from VAT, but there is an indication that taxis for example, will be brought under the VAT net.

There is also a list of zero-rated basic foodstuffs that are aimed at alleviating poverty. The zero rating for exports has created some problems with regards to cross-border activity, with goods crossing South Africa’s land borders by road. These have been addressed with strict documentation requirements.

*There is a big drive to move towards comprehensive electronic filing for all taxpayers*

Rather than offering an ongoing series of exemptions, rebates or subsidies, the introduction of VAT in 1991 was accompanied with structural reforms that sought to address the potentially regressive impacts of a consumption tax. Old age pension, disability allowances and so on were increased to cushion the least well-off from the potentially adverse impacts arising from VAT.

When the recent recession hit South Africa in 2008, there was a heated debate about the possibility of extending the zero-rating to other goods, but the argument was made that targeting exemptions would not have the desired impact. Generally speaking, the tax system is not seen as an efficient or effective way to drive benefits to individuals and particular socio-economic groups.





### **Compliance processes**

There is a big drive to move towards comprehensive electronic filing for all taxpayers. South Africa has a very effective e-filing system and that has had a positive impact on compliance. So, while there is no mandatory requirement as yet, the overwhelming majority of large taxpayers file returns and remit taxes electronically. There is some evidence that the tax authorities are using data analysis techniques to interrogate large taxpayers' returns. To date this has not been on a consistent basis and there is little feedback as to the outputs or uses to which data is put once it is collected by the revenue authority.

### **Enforcement**

The aggressive approach of the tax authorities continues to increase. One of the problems experienced by taxpayers is that an audit can impose a considerable burden of time and resource. An audit is likely to involve continuous requests for information and an emphasis on 'form over substance' in the way that audits are handled, can result in lengthy and inefficient procedures – particularly for multinationals that may have to retrieve documents from across their global operations in order to satisfy the revenue authority's requests.

SARS is increasingly taking, in common with tax authorities around the world, a risk-based approach that allocates a risk profile to taxpayers derived from their compliance record, sophistication of tax management systems, reporting systems and so on, in order to allocate them a profile that will inform the revenue authority's future approach. In response, multinational companies have tended to include South Africa in their Sarbanes-Oxley procedures to establish and test relevant controls and there is a general increase in the awareness and sophistication with which company Boards now approach tax.

### **Consultation**

In spite of a more aggressive approach to audit and enforcement, the tax authorities (the Treasury for policy and SARS for implementation) have been taking a decidedly more consultative approach to framing new policies, new laws and their own interpretation. A more inclusive approach is increasingly evident across the board, with a greater willingness to engage, reasonable timeframes for consultations, more scope for negotiation and generally more openness across the system.

### **VAT gap**

There is no reliable data available as to the size of any VAT gap, but given the considerable number of businesses with turnovers below RAND 1 million and a significant informal trade sector, there is likely to be a high degree of missing revenue. A number of programmes have been enacted to allow companies and individuals to amend 'errors' in previous tax submissions, without excessive penalties being levied against them.

### **Compliance data**

SARS estimates that their cost of collection across all taxes is 1.03 cents for every RAND collected. In the absence of major consulting costs or the expense of dealing with a major case, compliance with VAT is seen as relatively straightforward and comparatively low cost. Periodicity of returns depends on the size of the business, but there are cashflow implications that need to be balanced against the lower costs associated with less frequent returns for businesses with lower turnover.

### **Shifting the balance**

Largely owing to the comparatively low rate of VAT (14 percent), the proportion of taxes attributable to indirect taxes has gradually decreased.



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# *United Kingdom*

Steven Coleclough

PwC UK



## The UK's VAT regime continues to operate with a number of historical idiosyncrasies that differentiate it in some ways from most other EU Member States.

These are chiefly connected with the high VAT threshold that sees many smaller businesses in the UK not required to register for VAT and the persistence of zero-rating for VAT that applies to a wide range of consumer items.

The recent recession and the need to address a large fiscal deficit have seen the rate of VAT move up and down twice in as many years. The VAT rate now stands at 20 percent. In common with many other governments around the world, the UK faces the challenging task of securing tax revenues from increasingly global (and mobile) capital and businesses and this will increasingly shape tax policies.

While there have been no significant new areas of taxation in recent years in the UK, it is likely that consumption-based taxes that are broadly-based will form a major element of tax policies moving forward. The introduction of new environmental taxes also look set to move higher up the political agenda as governments around the world aim to tackle the triple challenges of a shift to a low carbon economy, energy security and fiscal deficits in the context of a volatile market-based carbon price.

### **Who is required to register?**

The UK is very unusual among EU member states, in having a high threshold for VAT registration. This allows up to £73,000 of turnover before businesses become liable to charge VAT. This is in marked contrast to other countries in the EU that include nearly all businesses within the VAT net. When the European Council of Ministers introduced a measure to exempt small, labour-intensive businesses providing services such as window cleaning, gardening and so on, there was no need to implement this in the UK owing to the existing high threshold.

The UK has three rates of VAT: 0 percent, 5 percent and 20 percent. Here again, the zero-rating on certain items (children's clothing for example), dates back to the UK's accession to the EU in 1973 and is a direct incorporation from the Purchase Tax that VAT replaced. While it is anomalous within the broader European context, the zero-rating is seen as almost politically untouchable in the UK. A reduced rate of 5 percent applies to some goods and services including energy supplies and building renovations. The remainder of goods and services are taxed at 20 percent.

Pressure for reform across the EU calls for a simplified regime with fewer differentials in rates. How willing the UK's politicians of any ideological bent will be to give up zero-rating remains very much open to question.

## *The UK is very unusual among EU member states in having a high threshold for VAT registration*

Exemptions also apply to public bodies, though this is an area of some contention as it arises from a time when many services now provided by the private sector in the UK were under state ownership. Holding companies have also been subject to litigation in order to challenge their VAT status and prevent them from recovering input tax.

### **Exemptions**

The main exemptions from VAT in the UK are financial services, housing, public sector and not for profit or charitable organisations. The existence of exemptions in the UK – many of which exist for historical reasons and were applied in contexts that are very different from today – is a continued source of contention. As the UK has only one land border with another EU member state (the Republic of Ireland), the distortions that are created by exemptions have a less obvious impact than in mainland Europe, where proximity to other countries makes shopping around a relatively straightforward proposition.

### **Addressing regression**

The objections to removing zero-rating stem from a concern about the regressive nature of consumption taxes. The UK is not alone in having to find ways to address those concerns. Doing so effectively will be a major element of any reform that tries to make VAT a broader-based system of taxation. Whether current exemptions and reduced rates are an effective way of achieving balances within the system is open to question. The extent to which changes at the margin have an impact on consumer behaviour is unclear. When the European Commission looked into the impact of making small labour intensive business exempt from VAT, it found no discernible change in economic behaviour. However, the immense complexity of balancing a broadening of the taxable base with concerns about redistribution will require integrated reform of tax and benefits.



### Compliance and enforcement

Another unique aspect of the UK's VAT system is the quarterly system of returns as opposed to the monthly returns required by other Member States. The UK also allows smaller businesses to make annual returns.

The UK Government is strongly committed to making all processes fully electronic by 2012. From 1 April 2010, all returns now have to be made electronically<sup>6</sup>. While this should make processes simpler, there are question marks over the capability of the UK broadband infrastructure – that is patchier than many of its European counterparts – to support a fully digital and online process.

Changing the way that information is exchanged between taxpayers and the tax authorities opens the door to new IT-based enforcement methods. These will enable far greater transparency, allow for benchmarking and comparison and use real-time data analysis and interrogation to search for anomalies and patterns in returns that may indicate non-compliance. However, while it is certainly the case that HMRC is keen to adopt these methods, the scale of the IT challenge to create the right systems should not be underestimated. It is likely to be a number of years before all taxpayer records and compliance processes will be managed digitally.

Large businesses have been adding to their VAT teams with senior hires often from the profession. This indicates the increased complexity that taxpayers experience in ensuring that they are compliant with VAT.

### Consultation

The largest ever European consultation on the reform of VAT will conclude at the end of May 2011. The feedback from UK business is very clear in its requirements. In essence, businesses want a simple and easy to implement tax system that is as predictable, easy to manage and comply with as possible.

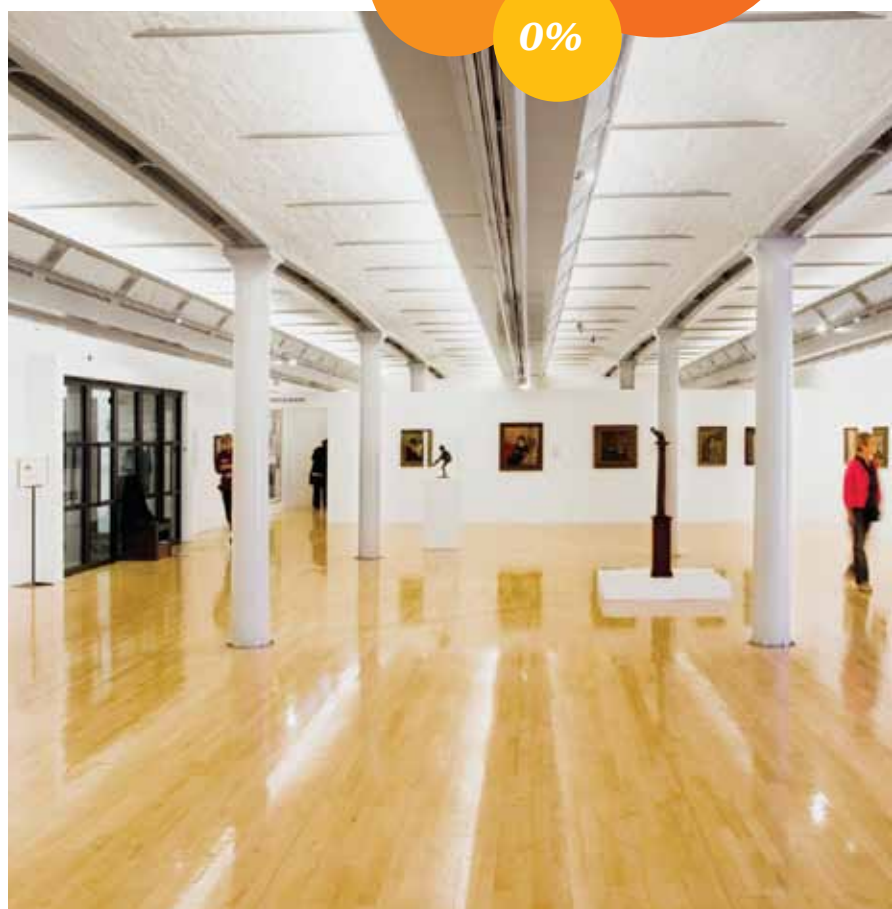
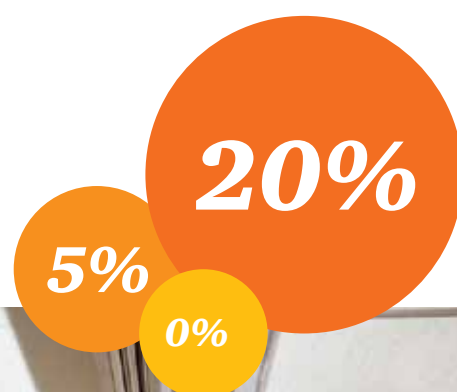
### VAT gap

The existence of a sizeable and, according to official figures, growing gap between what is collected in VAT and the Treasury estimates of the amount that full compliance should deliver, is open to some considerable debate. While inevitably there is a difference between the two figures, the estimated scale of the disparity has been disputed and the approach to modelling that is used by HMRC to calculate the gap may need revisiting. The size of the UK's financial sector and the ability of global financial institutions to recover more VAT than is reflected in current government models may be a major missing element from Treasury calculations.

### Shifting the balance

In common with many other countries, the UK has a major deficit to address. The importance of VAT and other indirect revenues as part of the government's fiscal armoury is likely to grow, particularly in light of direct tax policies designed to ensure the UK's competitiveness as an investment destination for global businesses.

#### Three UK VAT Rates



<sup>6</sup> Businesses with turnover below £100,000 as at 1 April 2010 can file paper returns until April 2012.



# *United States*



Tom Boniface

PwC US



## Will the USA introduce a VAT/GST?

The US is the only major economy in the developed world that does not have a broad-based federal consumption tax such as GST or VAT. And while there is no official policy towards adopting such a measure, the possibility of its introduction is beginning to be more widely discussed. The reason for this is simple. The scale of the US deficit is such that action is going to be required to address it soon. In 2009 the US fiscal deficit topped \$1.41 trillion and is estimated to reach more than \$1.48 trillion in 2011 under present law.

At approximately 10 percent of US GDP, the United States is already approaching levels that have seen other economies around the world run into major economic woes. Of course the specific circumstances of each country make it hard to draw comparisons based on deficit ratios alone. However, the OECD's analysis shows the US at levels that are very close to those of Ireland and Greece. At 62 percent of GDP, the US \$10 billion of public debt is not yet close to Greece and Ireland (144 percent and 94 percent respectively) but the numbers – and their projected growth – are causing serious concern. Discussions about possible remedies are both grave and urgent.

A number of prominent commentators, politicians past and present, ex-chair of the Federal Reserve Alan Greenspan among them, have suggested that the introduction of a VAT or GST may be the “least worst” option open to the US government as a means of raising revenue to combat the soaring deficit. However, popular and therefore political opposition to such a move is strong and splits roughly along party lines. Republicans generally reject the notion that additional taxation is desirable in any form, and Democrats are concerned about the perceived regressive nature of broadly-based consumption taxes.

President Obama created the National Commission on Fiscal Responsibility and Reform with the specific aim of investigating a wide range of means to reduce the deficit. Although a number of Commissioners recommended a Federal consumption-based tax as an important component of overall tax reform, aimed at increasing revenue, it was not included in the Commission’s final report. Introduction of an ‘add on’ consumption tax without elimination of the income tax was unacceptable to some Commissioners who feared this would enable an expansion of the size of federal government. With Democratic control of the Presidency and the Senate and Republican control of the House, a cross-party consensus would be the only feasible route for adopting a VAT, and that appears an extremely distant possibility in the foreseeable future.

Outside the political arena, however, there is a growing consensus among economists and academics that a VAT or a GST could be an effective means of raising additional revenue to address the deficit. The Congressional Research Service estimates that each percentage point of a broad-base VAT would raise in the region of \$50 billion annually over the FY 2012-2021 period. In his book, ‘100 Million Unnecessary Returns’, Michael Graetz, Professor of Law at Columbia University, has suggested combining a broad-based VAT at a rate of between 10 percent and 14 percent with reduction in the top individual corporate rates and exclusion of taxpayers earning below \$100,000 from the individual income tax system, as well as additional tax changes.

Businesses appear divided in their views, and those are largely determined by the extent to which specific sectors see themselves as susceptible to additional costs and eroding margins, arising from the introduction of VAT or GST. Retailers, for example, are likely to be strongly opposed. Others see it as the ‘least bad’ answer, in view of the possible alternatives, such as increased corporate income taxation.

What is certain, however, is that the growth in the US deficit and public debt are seen by many to be reaching unsustainable levels. Objections, whether ideological or pragmatic, to the introduction of a new consumption-based tax may start to seem of minor importance when compared to the scale of the problem that needs to be addressed. PwC will continue to monitor what is an increasingly urgent debate.



*There is a growing consensus among economists and academics that VAT or a GST could be an effective means of raising additional revenue to address the deficit*





## ***The impact of VAT compliance on business***

Value Added Tax (VAT) is now the most common form of consumption tax system used around the world. However, while the principles of VAT are similar everywhere, the compliance burden on business varies considerably. This is evident in the results of the Paying Taxes studies.



PwC has recently undertaken some further research to look in more detail at the differences in the time required for VAT compliance in different countries, and to go some way to understanding what drives this. In addition to data collected as part of the Paying Taxes 2010 study, further data was collected from 30 of the 156 economies in the study which had a VAT or similar value added consumption tax system. These economies were representative across the range of results for the time required for VAT compliance activities.

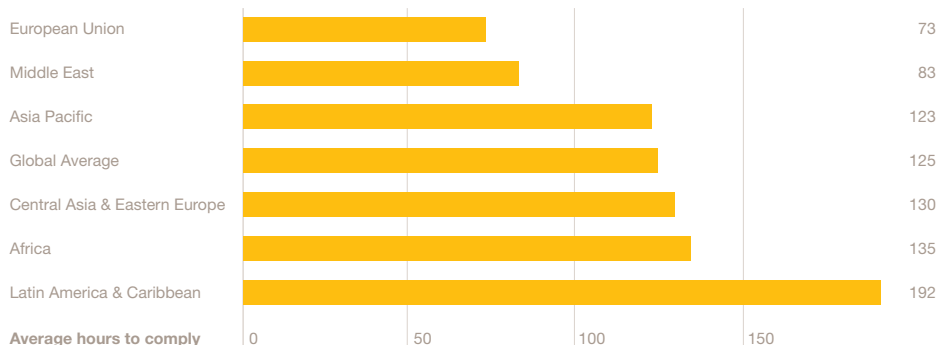
The results of the research are available at [www.pwc.co.uk/pdf/PwC\\_VAT\\_Compliance\\_survey\\_2010.pdf](http://www.pwc.co.uk/pdf/PwC_VAT_Compliance_survey_2010.pdf)

In summary, the results show that:

- On average it takes the case study company longer to comply with VAT than it does to comply with corporate income tax.
- The time needed to comply varies considerably around the world even between neighbouring countries.
- VAT compliance tends to take less time in countries where the tax is administered by the same tax authority as the one which deals with corporate income tax.
- On average it takes less time to comply where companies use online filing and payment for VAT.
- The frequency and length of VAT returns impacts the time it takes to comply.
- The requirement to submit invoices or other documentation with the return adds to compliance time.

Our research shows that different administrative practices and the way in which VAT is implemented are key reasons for the wide range in hours that it takes our case study company to comply with VAT requirements. Streamlining the compliance burden and reducing the time needed to comply is important for VAT systems to work efficiently.

#### The time needed varies by region



**Note:** Chart shows the average time needed to comply with VAT for economies in each economic/geographic region and the world average for all economies with a VAT.  
**Source:** *Paying Taxes 2010*, PwC analysis

#### It takes less time on average in countries where business uses online filing and payment



**Note:** Chart compares the average time to comply with VAT for economies in the sample group where business of the size and nature of the case study company file and pay VAT online. **Source:** *Paying Taxes 2010*, PwC analysis

#### The frequency at which VAT returns are required impacts the time to comply



**Note:** Chart shows the average time needed to comply in economies in the sample group depending on whether VAT returns are required to be made monthly, bi-monthly or quarterly. **Source:** *Paying Taxes 2010*, PwC analysis

#### The more extensive/long the tax returns, the more time is needed



**Note:** Chart shows the average time to comply per return for economies in the sample, depending on the number of boxes in the return which need to be completed.  
**Source:** *Paying Taxes 2010*, PwC analysis

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