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INDIRECT TAX Can Drive Costs For Shared Service Centers

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An arguable upside of the global credit crisis is that it provided many companies with an added impetus to look for ways to improve processes, manage costs, increase functionality, raise customer satisfaction, eliminate redundancies and extract additional value. One approach growing in popularity is migration to a shared service center (SSC) model.

About 27 percent of the respondents to a recent Ernst & Young survey of global executives indicated that they plan to increase their use of SSCs over the next year for functions ranging from property management to customer service, from information technology software and network management to human resources and accounting.

As varied as the drivers for this model and its uses may be, one common denominator is often missing from the discussion: indirect tax. And although these tax considerations may not be among the issues that drive a shared service decision, tax certainly can lead to some significant and costly challenges.

That is particularly true of the value-added tax (VAT), which hits a number of disparate points within the enterprise as diverse as finance, procurement, information technology or human resources.

For multinational companies, these touch points also can arise in a wide range of countries and taxing jurisdictions. As multinationals move steadily toward the shared service model to meet their varied objectives, the responsibility for indirect taxes migrates with them, primarily in the form of VAT and goods and service tax (GST).

Complexity in managing these taxes increases exponentially when cross-border activities are involved, especially in today's VAT environment, where all too often controls are external, processes are manual and procedures are not documented.

Historically, the activities around transactions giving rise to indirect taxes have been handled by in-country entities more familiar with local regulations and compliance requirements and accustomed to the rules and obligations for invoicing, liability, rates, accounting and reporting specific to each of the myriad jurisdictions.

But what happens when VAT and GST functions are transferred to an offshore shared service center in some faraway location? How complex will the operational requirements be when one SSC is dealing with countless transactions that originate in multiple countries and languages and fall under the auspices of a variety of cultures and authorities?

Executives are increasingly looking to SSCs for tasks as diverse as customer service, property management and human resources. And, though the reasons may vary, one key consideration is often absent from the discussion: indirect tax.

Getting ahead of possible problems before they arise in practice is one critical way to make sure that the company reaps the benefits intended from an SSC migration. VAT needs to move to the top of the priority list whether a new SSC is being designed or an existing one evaluated.

Examining Risks and Rewards

Since cost savings are among the most common reasons for an SSC, companies often go to what are considered low-wage countries such as the Philippines, Hungary, Poland, India and the Ukraine. An additional upside of these countries has been the availability of educated and multi-lingual talent.

Often overlooked, however, is a full understanding of the processes and controls needed to effectively and efficiently manage indirect tax. With this knowledge gap come important considerations:

Inability to comply with local VAT rules. Although the root cause will vary from one company and country to another, the risk is likely to arise because of the fundamental lack of resources with local knowledge, clear VAT policies and procedures, technology enablement and controls and metrics to facilitate and monitor compliance. In most cases, there is some combination of these causes.

System incompatibility. It isn't uncommon to find that the ERP system or other available technologies do not support SSC staff as fully or effectively as required for making sound decisions related to VAT.

Processes not clearly defined. SSCs sometimes find themselves operating without clear descriptions or instructions as to how certain processes should function internally. That typically includes specific division of duties and defined responsibilities for every task and the person assigned to perform it, as well as the protocols for communicating with the tax office to receive updated information, escalate issues and solicit valuable feedback. The more pieces missing, the greater the risk.

Nonexistent or inadequate processes and documentation. Since indirect tax guidance is not necessarily part of the SSC brief, SSC staff may not have access to VAT training, manuals or Web-based technology to support their decisions and activities relative to VAT.

Insufficient communications. Staff may be hampered by inadequate or unorganized communications between the SSC and other operational business units within the enterprise, making it very difficult to identify and address any crossover issues relating to VAT.

Nonexistent or inadequate compliance controls. An indirect tax control framework and key performance metrics that focus on relevant indirect tax risk must be in place to provide the stability and transparency required to both enable and sustain compliance.

None of these "risk drivers" are insurmountable or prohibitively complex to overcome. However,, there are some equally significant VAT-specific rewards in migrating to a well-run, well-founded SSC.

Performance improvement. Companies have seen a reduction in both manual effort and error rates in VAT processes from automating VAT decisions in an enterprise resource planning environment and/or using technologies available on the market, such as tax engines and certain Web-based applications.

Better time management. Tax staff has more time to set up and implement VAT strategy and planning. Since part of the VAT functionality is transferred to the SSC, problems can be anticipated at an earlier stage and action taken to pre-empt or solve them.

Process improvement. With the SSC doing a good portion of the "heavy lifting," the organization has more time and resources to review, adjust, structure and optimize existing VAT processes, which may include adding a VAT team to operate as part of the overall international tax team.

Consistency and flexibility. An efficient and effective SSC/VAT partnership can provide the company with both a consistent operating model and flexible organizational design to support growth, profitability and compliance.

Once the company has evaluated the risks and rewards and conducted any other due diligence, the processes begin for identifying the VAT-critical functions, diagnosing the current state and designing the structure that will enable the effective migration of VAT to SSC.

Identify, Diagnose, Design: Getting an SSC That Works

VAT must factor into every aspect of the migration process. Though the three mega-steps can be characterized as identify, diagnose and design, these are not necessarily discrete elements that take place only once. These same steps can, and should, be applied from time to time to an existing SSC to make sure that it is functioning as efficiently as possible and that it remains consistent with enterprise objectives in the event of changes in the business profile.

Complexity in managing these taxes increases exponentially when cross-border activities are involved, especially in today's VAT environment, where all too often controls are external, processes are manual and procedures are not documented.

Identify. Among the most common transaction-handling processes to migrate to an SSC are VAT-critical functions: accounts payable, general accounting, intercompany settlements, travel and expenses, tax filing, customer billing and order entry. Defining the scope of the SSC includes documenting the current VAT processes for the various local business units and determining what countries the SSC will serve and the processes for which it will be responsible. Supporting these decisions should be a realistic perspective on the available technologies and talent pool, with metrics for measuring their performance.

Centralizing functions into an environment like an SSC entails a shift of responsibilities and potential changes to current processes, which then requires establishing and documenting new protocols and new lines of communication. This early stage is the time for surfacing potential problems and their impact and identifying the timeframe and approach for addressing them.

The complexity of change that comes with implementing an SSC and its various support systems generates some critical considerations, so the company must fully understand the degree of change that's about to occur and communicate and manage it across the enterprise.

Diagnose. The goal is to make sure that the outsourced VAT function is transferred and continues operating as effectively and efficiently as possible. That means determining whether the current processes are satisfactory or need to be improved, factoring in their complexity and the ways they vary in each of the business units the SSC will support and potentially optimizing the VAT functionality of the ERP system.

Some systems and tax engines include the option of using a condition table or decision tree to determine the appropriate VAT action without human involvement. This virtual VAT manager establishes the VAT qualification for each transaction by allocating a tax code to yield a specific VAT result.

Current and future processes must reflect new customers, flow of goods, legislation and other such changes and be entered into the system accurately and in good time. The system also must include adequate controls so that transactions outside the scope of the condition table/decision tree cannot be completed without involving an appropriate VAT expert.

These questions can help in assessing and managing the impact of VAT prior to SSC migration:

- Is there sufficient insight into current VAT processes, including all manual adjustments, workarounds and internal quality assurances processes?
- Are the processes well-documented, adequate and specific to the new environment?
- What personnel changes may occur in migrating to the SSC and is all the relevant knowledge being captured from those who may decide to leave the organization?
- Is there ongoing access to and information about existing manual processes and procedures and offline solutions?
- How dependent are current processes on local VAT expertise and technology? How much will be lost in the event of a transfer to SSC?

- To what extent are different processes required from one jurisdiction to another?
- Who has final responsibility for the VAT compliance process at present and who will own it in the SSC model?
- Where are the essential process controls being carried out?
- How does the SSC model deal with local VAT risks in terms of internal communication and coordination?

Design. There are no standard solutions, just the central requirement that any solution be VAT-compliant. What the future SSC/VAT interface will look like will depend largely upon the complexity of the transactions to be handled and the type of technology and talent available.

If the SSC design will be based upon the organization's existing ERP system, it's essential to know from the outset how well its structure and functionality will support the completion of VAT processes.

Equally important is knowing the extent that technology will be used for electronic invoicing, tax engines, tax reports and other VAT-specific processes, and making sure all are in keeping with local VAT rules and guidelines.

Will VAT compliance be based on an integrated ERP system or multiple applications? An infrastructure comprising a combination of applications is more likely to need manual adjustments for consolidation and other purposes, which can mean higher margin of error and greater VAT risk. If employees with limited knowledge of VAT end up responsible for manipulating and entering data, this raises the question of whether the data can be considered sound.

In worst-case scenarios, the company can find itself at risk for the full VAT amount owed plus penalties of up to 100 percent, conceivably overshadowing the potential benefits of an SSC migration.

Upfront Agreement and Alignment

Underpinning all the activities in identifying, diagnosing and designing the SSC's treatment of VAT and GST are transparent communications and a well-defined service level agreement that participating parties understand and support fully. That must include the responsibilities both within and outside the SSC, the division of duties and the protocols for communicating, resolving and escalating issues.

Before the processes are transferred over, thoroughly vet each one to confirm:

- Overall efficiency and functionality;
- Feasibility within the SSC model;
- SSC resources required;
- Impact on current state and ongoing processes;
- Impact on ongoing processes; and
- Critical success factors and performance measurement.

View rollouts holistically to understand and effectively manage the demands upon corporate and SSC resources as well as the return on investment for each major initiative. Likewise, integrate the VAT work stream with contingent technology and finance projects.

This may prove challenging as a number of initiatives, particularly those dealing with systems development and technology enablers, may not be visible to the tax function — another point that underscores the need for transparency and upfront communications. Failure to align with initiatives that intersect with VAT can result in a design that is inefficient from a process perspective and not a "best fit" for the business.

Underrating VAT — Some Cautionary Notes

Global indirect taxes can amount to as much as 75 percent of the overall corporate tax burden, with VAT and sales/use tax outlays nearly 40 percent of total business tax expenditures — almost twice as much as corporate income tax. And the more taxing jurisdictions around the world focus on taking in VAT revenues, the more prevalent the VAT audits.

Underrating the impact of VAT and failing to factor in its implications throughout the SSC design can mean huge financial consequences:

- An oil and gas company had to pay $2 million in VAT instead of getting the refund it expected in the same amount.
- A mining company was assessed $500 million in taxes and penalties because it lacked the proper documentation.
- A consumer products company missed out on a $20 million VAT refund.
- A *Fortune* 100 company saw its officials put in jail because of personal liability.

Granted, not all these outcomes arose from the shared service model, but they were a direct result of failing to properly handle VAT. When SSCs are vested with the responsibility for VAT, the potential for risk at this level follows.

The levers for performance improvement that must be addressed to comply with VAT will also help to fully optimize shared services and enhance the sustainable value. With proper planning for an SSC that manages VAT appropriately and proactively, the pain of noncompliance can be replaced with the gain of a leading practice SSC model.

And that means managing by design — looking at any process or transaction from end to end and factoring in all the requirements and controls essential to a compliant and high-functioning VAT process.

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