

10. What Every Trading Company Needs to Know About: Distribution Structures in International Trading - Taxable or Not?

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Traditional business models are in movement. Due to digitalization, efficient and intelligent globalization and cross border expansion of a company's activities, there is a need for new business models. The solution for this economical need is the dynamic supply chain model which increases the ability of the company to adapt to changes in customers' demand or supplier markets and contributes to reduce the production time to the market since it allows a faster deployment of resources and innovation in product development and design.

However, such business models also increase the complexity from a VAT and income tax point of view. At least in Switzerland companies can benefit from the lowest VAT and income tax rates in Europe (e.g. 8% for standard VAT rate, compared to between 15 and 27% in the EU). Lower rates mean lower risks. However, do not pass the margin to the local tax authority unnecessarily due to a neglected acting! A careful analysis is needed.

Traditional Business Models: Limited Risk Distributor (LRD), Commissionaire Structure and Disclosed Agent – One-to-One Relationships

The traditional business models focus on single steps and one-to-one relationships.

Limited risk distributors which act in their own name and for their own account have generally a very limited business activity: reselling of products of the principal. Their remuneration is the margin between sales and purchases. Firstly, the legal title of the product will be transferred from the principal directly to the LRD, followed by the LRD's flash title of the products and, finally, from the LRD to the end customer. While LRD models are quite straight-forward from an income tax point of view, VAT needs to be reviewed and considered based on the sales activities from the principal to the LRD and from the LRD to the end customers. Hence, the transfer of title can lead to multiple VAT registrations of the principal including more compliance and admin work. The more jurisdictions there are involved, the more VAT registrations are generated. In addition, it can cause unnecessary customs implications in specific cases.

In case of a commissionaire structure, the commissionaire acts in its own name, but for the account of the principal. Commissionaire structures are often used to centralize profits at the principal location outside high tax jurisdictions, and it is, therefore, important that no permanent establishment (PE) of the principal is created abroad. However, the OECD is pro-actively attacking such structures in its report on base erosion and profit shifting (BEPS). It proposes a change of Art. 5(5) and 5(6) of the OECD model treaty: As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a taxable presence in that country unless the intermediary is performing these activities in the course of an independent business. Hence, the PE risk in such structures will increase substantially. From a VAT point of view, the supply of goods through a commissionaire, referred to as an undisclosed agent, which purports to act on

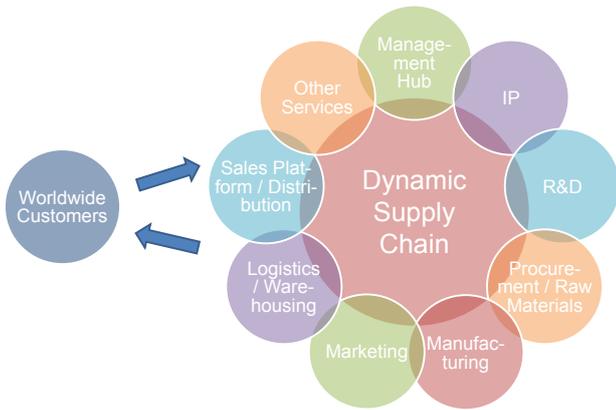
his own behalf and concludes agreements, but actually acts on behalf of the principal, shall be regarded as a supply of goods to and by that commissionaire. The commissionaire will be regarded as receiving supplies from the principal and supplying them to the end customers. The commissionaire will charge VAT on the supply in the normal way, if applicable. In addition, a commissionaire will be liable to VAT on the commission he charges to the principal. This type of traditional business model causes multiple VAT registrations and admin and compliance work for the parties involved in the structure. As always, it is essential to clarify who supplies to whom, what and where.

It seems that the disclosed agent structure has an easier VAT handling since the disclosed agent acts in the name of the principal and legal title of the product is directly transferred from the principal to the end customers. However, expansion and involving new disclosed agents can lead to multiple VAT registrations of the principal. In addition, the PE risk is increased as well.

Dynamic Supply Chain (DSC) Models – a Jungle of Relationships

Dynamic supply chain models which are based on digitalization allow for maximized synergies and economies of scale. This is reflected in the ability of the company to adapt to changes in customers' demand or supplier markets. It also contributes to reduce the production time to the market, since it allows a faster deployment of resources and innovation in product development and design. Further, the dynamic supply chain increases transparency in management accounting, improves the visibility of the value drivers in business lines and provides management with an opportunity to draft further guidance aimed at improving efficiency and growth. Time, delivery and transport will be more important. The delivery needs to be faster and faster as the end customers determine the market and the time will determine the success of the sales business. E-commerce businesses are booming - only one click is needed and the dynamic supply chain is initiated.

However, dynamic supply chain models do not involve straight-forward one-to-one relationships only. In cross border activities, such models increase the complexity since the physical flows do not necessarily coincide with multiple contractual or economical flows which might be initiated in some seconds. Generally, all strategical decisions are still centralized in a management hub owning the IP (but decisions are maybe taken more and more in a automated process), while other group companies undertake procurement, manufacturing, distribution, research, development, logistics or other services usually with a low functional and risk profile, but in a digitalized environment with direct access and less boundaries. VAT and income tax need full attention in such business models. The mapping of transactions, flows of goods and flows of supplies are even more important as unnecessary VAT costs or PE risks could be significant.



The following checklist should help companies to monitor and to review their dynamic supply chain, regardless where their business performs activities:

1. Always map the transaction. It generates more clarity.
2. Indicate the contractual relationships. It gives you legal security.
3. Clarify who provides to whom what and where. It determines the VAT liabilities for the involved parties.
4. Indicate the flows of invoicing.
5. Indicate the delivery conditions, and who organizes the transport.
6. Indicate the locations and the countries involved in the dynamic supply chain.
7. Analyze PE risks (e.g warehouses and agents)
8. Indicate the volume of the business.
9. Review and amend existing rulings. Be aware of the exchange of information.
10. Clarify the VAT and Customs status including the legal status of the parties involved. Ask always for simplifications.
11. Review and consider your customers' details (name, address, VAT number).
12. Arrange for the validity check of the applicable VAT numbers.
13. Check your own VAT liabilities and registrations.
14. Check the input VAT (refundable – not refundable/deductible VAT costs).
15. Make deadlines as the reimbursements are linked with deadlines, and consider limitation periods.
16. Monitor year end adjustments (see below).
17. Review and consider the contracts especially with toll/contract manufacturers. Show VAT tendencies in relation to over- or under-consumption of raw materials by the toll manufacturers.
18. Check the distribution model. In general, the principal needs to be VAT registered at the place where the inventory is physically located. Check simplifications, if applicable.
19. Avoid netting. In case of supplies vice versa, make sure that each supply is checked and clarified for VAT purposes.
20. Royalties, intangible rights, trademarks, tradenames, IP transactions are taxable transactions. Consider the applicable VAT jurisdictions.
21. Monitor compliance for tax and customs purposes.
22. Review and consider VAT coding and ERP systems.
23. Monitor the development of taxation including changes of the practice of the various authorities and update rulings.
24. Ask for help, if needed. Professional support can be your opportunity.

Additional Price Adjustment

As said, year end adjustments must be carefully monitored. In many cases they open the door for VAT issues at the latest, as these adjustments can dramatically influence the VAT situation and the potential customs impacts. The adjustments can be upward or downward. Issuing an annual invoice or credit notes in favor of the customer can have an impact on the turnover of the supplier and on the input VAT deduction by the recipient of the supply. As the income tax regimes have only two types of obligations, i.e. (1) filing of tax returns and (2) payment obligation of tax due, in addition, the indirect tax regime (VAT, customs etc.) prescribes the self assessment. The company is responsible to check its indirect tax liabilities and the VAT registration obligations and to make sure that the figures declared in its VAT return are formally completed and materially correct. Misuse of the VAT concept leads to penalties and punishment.

Compensating annual adjustments needs to have specific attention. In connection with the VAT treatment of the additional adjustments, there are three alternatives. If the adjustments are linked with the prior supply, the additional invoicing for the adjustment can be proven through the existing contractual relation between the supplier and customer. However, additional price adjustments have an impact on the VAT declaration by the supplier and VAT deduction status of the customer. If customs declarations are involved, in some cases these adjustments need to be corrected for the customs authorities, too.

The compensation annual adjustments could also be treated as a separate supply. From a VAT perspective, it is likely treated as a supply of services; however, the correct VAT treatment and qualification of the supply needs to be considered by the applicable jurisdiction. Each national legislation can have specific guidelines with regard to this type of adjustments. In some cases the direct link for the payment and the identification of the supply need to be correlated. This is also the case in Switzerland.

Lastly, the compensation annual adjustments could be qualified as contributions to capital. In this case, there are no VAT impacts at all as the contributions are treated as non taxable transaction for consideration.

Conclusion

From a tax rate point of view, Switzerland is a low VAT and income tax risk country. The standard VAT rate of 8% and ordinary income tax rates as low as 12% allow companies to have more flexibility creating new structures. As global traders are heavily investing in dynamic supply chain models, the traditional business models with clear one-to-one relationships seem to vanish. Although these business models have generated multiple VAT registrations of the principal, they have generally been quite straight-forward. Newly, dynamic supply chain models are introduced in order to be more flexible and to consider the customer demands immediately. Time, delivery, transport, and immediate action depending on the market needs are important. However, such dynamic supply chain models create a jungle of relationships. Unattended, unmonitored transactions can lead to unnecessary VAT costs and PE risks. A sample of checklist can help tax payers for ensuring against risks.

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