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GUIDE

The SaaS finance leader's guide to VAT compliance

A modern software business has customers all over the world—and often, a high volume of individual sales. Each of those transactions can be subject to different tax laws and regulations, depending where the customer is located.

While staying on top of complex and always-changing US sales tax laws is hard enough, SaaS companies who make sales across borders face the added challenge of complying with diverse rules around the globe.

In many cases that means accurately charging and accounting for value-added tax (VAT), a type of tax that doesn't exist in the US. Handled properly, this tax is passed on to customers at the time of sale. But the complexities of managing VAT regulations and processes all over the world often prohibit companies from prioritizing compliance—and they end up paying that VAT out of pocket instead.

Getting ahead of VAT compliance can help your business avoid large and unnecessary costs down the line. This guide is for SaaS companies based in the US who want to understand their tax obligations on sales made to customers located internationally.

Read on to learn everything you need to know as a SaaS finance leader or startup founder about getting and staying VAT compliant.

What is VAT?

VAT is a type of transaction tax levied on goods and services in more than 170 countries around the world. Like sales tax in the US, it is an "indirect" or "consumption" tax, meaning that the tax is not paid by the business making the sale, but by the consumer making the purchase.

VAT rules vary across the globe, and different rules can apply to your business depending on where you are located and what kinds of goods or services you sell. Remote sales of digital goods and services—including software-as-a-service subscriptions—are subject to a simplified version of local VAT rules in many jurisdictions.

Just as with US sales tax, regulations for cross-border sales have undergone recent developments. The European Union was the first to implement these rules in 2015. Prior to that, no VAT at all applied to cross-border digital goods and services sold in the EU. In the wake of this change, more than 80 countries around the world have adopted similar regulations, making VAT compliance a necessity for global software businesses.

Businesses that comply with local VAT regulations are able to pass any tax owed on to the customer. But it's important to note that without the proper processes in place, your business could be on the hook for paying VAT out of pocket, plus penalties, fees, and interest.

How does VAT compare to US sales tax?

SaaS companies based in the US are often more familiar with local sales tax rules and regulations. As you start to assess your VAT obligations, here are some key differences between sales tax and VAT to understand:

Higher tax rates

The average combined state and local sales tax rate in the US is between 7–8%. Outside of the US, VAT rates are often much higher. For example, the average VAT rate in Europe is 21%. Higher tax rates mean a potentially higher cost for businesses who aren't VAT compliant.

Special rules for B2B sales

To facilitate cross-border trade, many countries with VAT treat B2B and B2C sales differently. VAT is typically not charged on B2B transactions, and only remote sellers with B2C sales are typically required to register, file, and remit VAT. To prove that a transaction meets these requirements, B2B sellers need to collect and validate VAT IDs.

A VAT ID (also known as a VAT registration number) identifies each entity that is registered for VAT in a particular jurisdiction. VAT IDs allow tax authorities on both sides to see that the companies involved followed regulations concerning cross-border transactions. Collecting this number from customers on each transaction is necessary, because it can determine whether VAT needs to be charged, and impact your obligation to register and file returns in a given jurisdiction.

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Simpler registration thresholds

Outside the US, you won't encounter the concept of nexus. Instead, most VAT regimes have registration thresholds. Once a business reaches a certain amount of sales, they're required to register with that jurisdiction. Each country has its own registration threshold, and some can be as low as zero. For example, in the EU and UK, your first sale to a B2C customer would trigger a registration obligation.

Unified VAT rates

US-based businesses may be used to needing to pinpoint customer location information to apply the correct state and local tax rates. Internationally, VAT rates usually apply on a per-country basis, so the location information for your customers does not need to be quite as precise.

How does VAT apply to SaaS?

More than 80 countries apply VAT to digital goods and services transactions, including those categorized as SaaS.

To determine whether VAT applies on a sale of your product or service, there are three main factors to understand:

1. Your customer's location

First, you'll need to identify the location of your customer. Businesses must collect evidence of customer locations as part of each transaction in order to determine if and where VAT applies.

Common pieces of evidence for customer location determination are:

- Billing address
- Customer account address
- IP address
- Credit card country

The selection process for which pieces of evidence best represent the customer's location are unique to each business.

2. The taxability of your product in that country

Next, you need to understand whether your product qualifies as a digital good or service for VAT purposes. While the answer to this question can vary slightly between individual countries' VAT rules, some general factors do apply.

A product is typically considered a digital good or service if it:

- is delivered over the Internet or an electronic network
- is essentially automated and involves minimal human intervention
- would not exist without technology
- is not a physical good

Here are some common examples of digital goods and services:

- Downloading or accessing software (such as SaaS)
- Cloud computing services
- Streaming or downloading movies, TV shows or music
- Website hosting or remote maintenance
- Electronic supply of images, text, or information like e-books
- Downloadable or online games

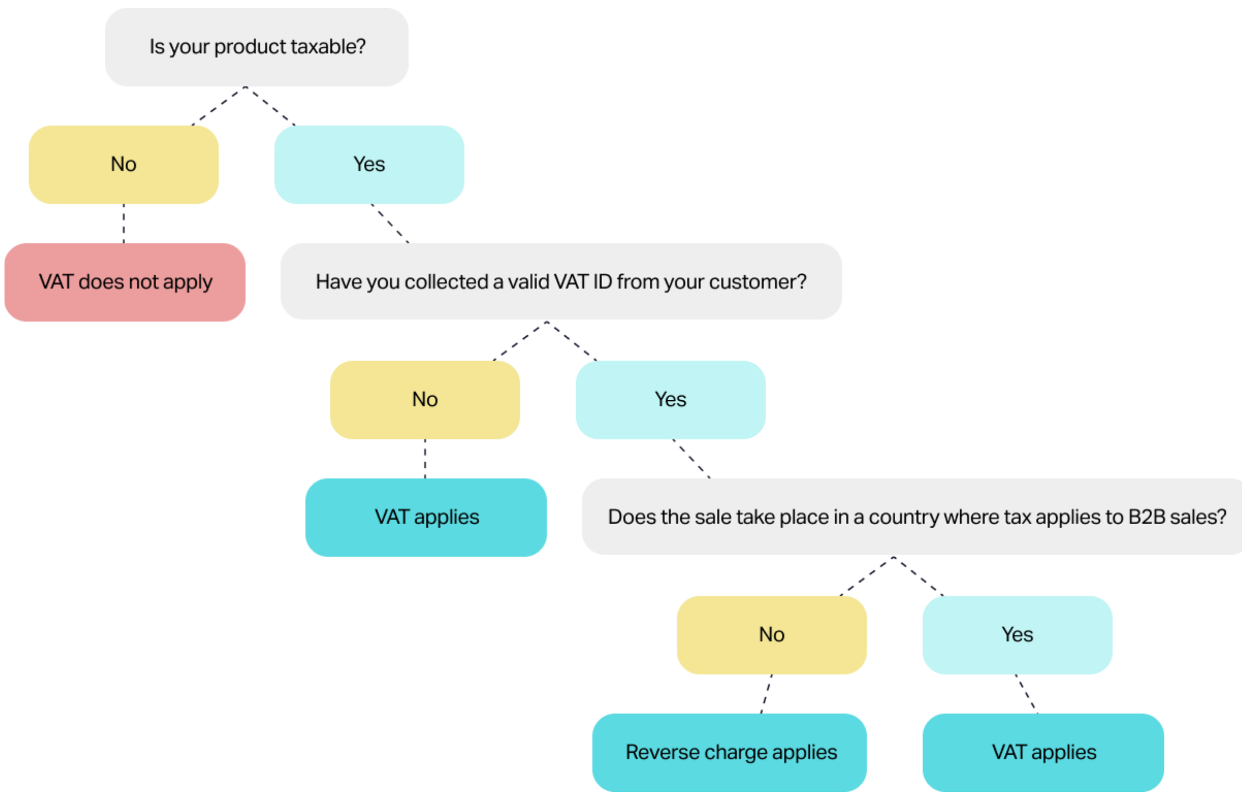
3. Your customer's VAT registration status

If you sell to other businesses that are located in the VAT countries, you should collect a VAT registration number from those customers and validate that number.

In many countries, if you meet those requirements, VAT is not charged on B2B sales. Instead, B2B transactions are subject to a "reverse charge," which transfers the responsibility of accounting for VAT from the seller to the buyer. In most cases, if the buyer provides appropriate documentation, VAT is not applied to these transactions.

Importantly, the reverse charge mechanism keeps B2B sellers from having to register and file if the right process is followed. B2C sales, on the other hand, are subject to VAT and can require remote sellers to register and file in the country of sale. Without proper documentation, B2B sales can also be treated in the same manner.

To comply with VAT regulations and take advantage of the simpler requirements for B2B sales, businesses must collect and validate VAT IDs on each transaction. If a valid VAT ID is collected and stored, B2B transactions typically require no further steps for the seller. But if a customer does not have a VAT ID or provides an invalid one, the seller is required to charge VAT on the sale (once they've met the threshold of sales and registered to collect VAT in a jurisdiction).



What are the steps to getting VAT compliant?

VAT regulations can be complicated, and it's important to make sure you're following the right process. Here are the high-level steps a US-based SaaS company should take to become VAT compliant.

- **Collect customer addresses and VAT IDs.** If you are selling to customers outside the US, this is a step you can take right away—whether you plan to start remitting VAT now or not. Even if you are not registered for VAT, collecting customer VAT IDs can save you out-of-pocket VAT costs in the future.

- **Understand where you have VAT obligations.** Cross-check your customer locations and the products you sell with the product taxability and registration thresholds in those countries.

- **Monitor your VAT exposure and register for VAT in exposed jurisdictions.** This can be time-consuming if you sell widely around the globe, but it's a necessary step. Registration is simplified in the EU into the OSS process, where you register with one member state on behalf of the entire EU.

  Example registration thresholds:

Jurisdiction	Registration threshold
European Union	First B2C sale
United Kingdom	First B2C sale
Australia	75,000 AUD in B2C sales
New Zealand	60,000 NZD in B2C sales
South Africa	1 million ZAR in B2B/B2C sales

  Note: A sale is considered B2C if the transaction is without a valid VAT ID. This is required to verify that the sale was indeed made to a business.

- **Apply VAT where necessary.** Identify transactions that require VAT collection and apply the correct rates to those invoices. You should validate VAT IDs for B2B transactions so that you can exclude VAT (with the right back-up documentation in place).

Example VAT rates in March 2023:

Jurisdiction	VAT rate
United Kingdom	20%
Hungary	27%
Switzerland	7.7%
Poland	23%
France	20%

- **File VAT returns and make payments.** You will need to periodically file VAT returns with the jurisdictions in which you sell. This is your way of reporting the VAT you have been collecting and remitting in a given period. Prepare to perform foreign exchange conversions and make cross-border payments in foreign currencies. Most accounts payable teams are not set up to pay in foreign currencies, so it's necessary to coordinate with your internal teams.

  Example filing frequencies:

Jurisdiction	Filing frequency
European Union	Quarterly
Australia	Quarterly
Japan	Annual (sometimes with quarterly payments)
South Africa	Bi-monthly
Singapore	Quarterly

- **Keep records.** In the EU, you're required to keep VAT records for at least 10 years. Research the requirements in other jurisdictions and keep these files on hand for the requisite amount of time.

Managing the VAT collection, remitting, and reporting process can be made far easier with the help of specialized VAT compliance software. Anrok is the only global sales tax and VAT platform built specifically for SaaS—with exposure monitoring, VAT ID validation, and more built right in.

What are the risks to delaying compliance?

VAT adds complexity to your accounting and operations, so it may be tempting to put compliance off for another day. But there are several risks to delaying compliance, some of which can add up to big trouble if you're doing extensive or even moderate amounts of business internationally.

- **Audits.** Since VAT legislation for digital goods is relatively new, audits for international sellers are increasing every year. Facing an audit for which you aren't prepared causes stress and could result in fees and penalties that will hurt your business.

- **Paying out of pocket.** You're responsible for VAT on the sales you make regardless of whether you get your customers to pay it to you or not. If you're audited or even just register late, you could be on the hook for the tax you should have collected from your customers, along with penalties and fees.

- **Reputational risk.** When you try to expand business internationally, you may be asked about your compliance with VAT rules. In the worst case, you could be blocked from doing business in a jurisdiction, leading to reputation harm for your business that you could have avoided. Your business customers may also question your maturity if your sales process neglects basic VAT rules.

SaaS finance leaders need to know about VAT

Learning about VAT and how it works is a smart move for SaaS companies with global ambitions. Far more countries in the world use VAT than sales tax, and SaaS companies are likely to sell into some of them—or maybe many of them—eventually.

It will pay to become familiar with how the system works, what rules govern digital products and services, and how to approach compliance. Removing friction to selling globally can unlock a larger market for you instantly.

If you're ready to start understanding your VAT obligations, reach out to our team to learn how Anrok's global tax platform can help streamline this process.