

SMES AND GLOBAL GROWTH: NAVIGATING THE LEGAL AND TAX MAZE



Even within a free trade zone, exporting can be complicated by varying national regulations and tax regimes; outside of free trade zones, the complexities multiply

American statesman and inventor Benjamin Franklin once famously said that nothing is certain in life except death and taxes. Nowadays, no one is more painfully aware of that—at least the part about taxes—than small and mid-sized enterprises (SMEs) entering foreign markets for the first time.

The complexity of foreign tax, regulatory and legal regimes is the most frequently cited reason why SMEs avoid foreign markets. The range of such barriers is wide, encompassing different tax treatment for similar products in different countries, varying product-composition and packaging rules, different standards for protecting intellectual property (IP), and complicated customs clearance procedures even within a free trade area. While the specific legal and tax barriers vary widely, they all represent essentially the same problem for SMEs: high compliance costs and the risk that, when implemented, regulations will be interpreted in unfavourable ways.

Such risks and costs are at the root of SMEs' reluctance to export. According to the Confederation of British Industry (CBI), only one-fourth of European companies export. Dutch entrepreneurs' association MKB-Nederland says that only 20% of Dutch companies export; according to a survey by logistics giant UPS, only 10% of French companies export.

Complex tax and legal issues also explain why SMEs that do export tend to do so only within a free trade area. A large-scale survey of SME owners and directors in seven European countries, carried out by UPS¹ in 2015, found that, in four of the seven countries looked at, the complications of clearing customs or of complying with export regulations was among the top three reasons for not exporting outside of the European Union.

Overall, around 80% of EU-based SME exporters confine their exporting to the EU, according to Ben Digby, the CBI's international director. Others venture farther afield, but to markets with which the EU has a free trade agreement, such as South Korea. An example is offered by UK pottery and tableware manufacturer Portmeirion: It says its export business to South Korea skyrocketed after the country signed a free trade agreement with the EU in 2010. By 2011, South Korea had surpassed the company's home market in the UK, and became its second-biggest market after the US.

¹ https://www.ups.com/media/news/en/gb/European_SME_Exporting_Insights_Study_2015.pdf

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A LABYRINTH OF HEALTH RULES

Examples such as Portmeirion's should not suggest that a free trade agreement sweeps away all legal and regulatory complications for exporters. Nothing could be further from the truth. Even within the EU single market, among countries with similar standards for products and services, legal and regulatory hurdles arise for exporters. An example is the maze of national rules that determine which pharmaceuticals qualify for medical prescriptions within the national health system.

Laboratoires Expanscience, a French pharmaceuticals SME specialising in skin cosmetics, faced such a problem in the UK. It entered the UK market a few years ago with, among other products, a range of skin creams under the Mustela brand; the creams are used for treating babies' minor skin problems, among other uses. However, the firm's UK sales are limited (currently below £1 million a year) because its products are not registered for prescription by the National Health Service (NHS). Registering with the NHS is an expensive and time consuming process: Raj Sandhan, the managing director of Expanscience's UK distributor, Metro Health and Beauty, says that one of the French firm's competitors had to wait five years to receive NHS approval. As a recent entrant to the market, Laboratoires Expanscience sells its products instead over-the-counter in independent pharmacies, which limits its sales volumes.

Family-owned with annual revenues of €272m, Laboratoires Expanscience is an active exporter, with subsidiaries in 14 of the 85 countries in which it sells. More than half its total revenue comes from foreign sales. Although it has not applied for NHS approval, its Mustela products are widely available on prescription in other countries. Its Béb  123 Vitamin Barrier Cream has been classified a drug in the US, meaning that it can be sold on prescription, as well as through retail chains such as Walgreen's. Obtaining such approvals can be a long process, the firm has found; but the resulting increase in sales that such approval brings makes that investment worthwhile.

INTRICACIES OF VAT

Registering for reimbursement of value-added taxes (VAT) also presents a hurdle for many exporters, even within the EU single market. National VAT rates for the same product vary considerably across the EU: the standard rate varies widely, from 19% in Germany to 21% in the Netherlands and 24% in Greece. Moreover, some states impose 'additional' taxes on imported products, leading to variations in tax treatment even within the EU. Belgium taxes imported bottled water and fruit juices, for example, whereas neighbouring France does not. All this causes headaches for importers, who must comply with a patchwork of European tax rules.

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At company level, the VAT quilt in Europe causes other types of problems. To receive reimbursement for VAT paid, a company must register with national authorities. The threshold for VAT registration varies widely among EU member states, from €10,000 in Portugal to £83,000 in the UK. One SME dealing with the VAT registration rules is Emois Gourmands, a UK start-up selling French gourmet food in London. Emois Gourmands founder and CEO Cecile Faure says that her firm buys directly from producers in France, does not use middlemen and does not add a big mark-up, thus enabling it to sell products at lower prices than UK supermarkets charge.

But Ms Faure says her firm's small size puts it at a disadvantage in the VAT department. Her firm is not large enough to qualify for VAT registration in the UK. To avoid paying VAT on imports without being able to offset the tax payment through sales, Ms Faure has to hire a freight forwarder to make the upfront payment. Details such as this can make even a deep free-trade area such as the EU less free than intended. "I applied for VAT registration several times but was repeatedly tuned down," says Ms Faure. "It's expensive for a small company."

UNRAVELLING CUSTOMS CLASSIFICATIONS

A further complication for SMEs is finding a way through the thicket of regulations governing customs clearance and customs classification. An export product's customs classification is more than just a number: it is a unique identifying code which determines the product's tariff and VAT treatment, if applicable, and whether the product is permitted to be sold in the destination country in the first place. Some defence-related products, for example, are subject to both export- and import-restrictions. In theory, the World Trade Organisation's standard product classifications take all the mystery out of identifying products. In practice, it is not so simple, since the WTO's guidelines can be applied inconsistently across countries. This causes problems for all types of companies, but SMEs, with their relatively limited resources, can be hit particularly hard.

Varying classification of the same product can appear even within a single market such as the EU, according to Christine Debats, international development manager at Conex, a small French company that handles customs clearance for importers and exporters. Television set-top boxes are classified according to their main function, for example. If this is deemed to be recording broadcasts, then imported boxes are subject to a tariff of 13.9%. If the main function is considered to be internet access, then the duty is 0%. The ambiguity comes when the box does both things—leading to a WTO ruling that the EU's customs treatment of set-top boxes was out of compliance with its rules. That ruling, in turn, forced the EU to issue a complex set of new rules for classifying set-top boxes. This example shows how standardised customs classifications sometimes do not keep

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up with the rapid pace of product development, making it hard to predict the customs treatment of some goods.

But modernising customs classification and clearance can bring pitfalls of its own. In May 2016 the European Commission introduced the Union Customs Code as part of an effort to modernise customs. The initiative aims to enable traders to file all customs declarations remotely by 2020. This will require joining together all of the disparate IT systems used by EU countries—a hugely ambitious undertaking involving a host of detailed changes to the customs treatment of products. This is a huge challenge, considering that “customs classifications change constantly,” says Ms Debats.

PATENT ‘PROTECTION’: ENTER THE TROLLS

Other official attempts to promote efficiency and reduce the paperwork burdens of exporters and investors within the EU are causing a different set of problems. The EU’s planned Unified Patent Court, which is expected to start operating this year, will enable pan-European patent protection via a single filing, thereby cutting the cost of filing patents in multiple national jurisdictions. However, the unified system will also increase the risk of facing patent infringement challenges all across the EU rather than in individual countries.

That risk is increasingly a reality for exporters to and within the EU, as a result of the appearance in Europe of so-called “patent trolls”. These are firms that acquire patents to technologies that they have no intention of developing themselves, for the purpose of blocking others from using the technology. The patent trolls prevent the use of those technologies by threatening firms developing those technologies with patent infringement lawsuits.

The practice originated in the US, where patent trolling has become a big business. Specialist patent trolls are joined by multinationals that actively buy and police patents in their sectors. A surge in patent litigation has led the federal government, as well as some US states, to clamp down on the trolls. One result of the US clamp-down “is that the patent trolls have come over to Europe,” says Edward Borovikov, a lawyer in France with global law firm Dentons.

So far, many of the problems have centred on Germany, where the courts support patent-holders’ rights vigorously (as they do in the Netherlands), Mr Borovikov says. However, the pan-European patent system increases trolls’ potential rewards if they win a case, since compensation will be calculated across the entire EU and not only in the affected country. “A case will cost at least €200,000-300,000, which SMEs simply can’t afford,” says Mr Borovikov. “Twenty years

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ago, intellectual property was not a huge concern in Europe. Now companies must check very carefully for possible patent infringements to avoid being sued by trolls."

Patent trolls are a particular threat to SMEs. In the US, half of all patent troll lawsuits are against companies with revenues of US\$10 million or less. The average cost of defending such lawsuits is US\$3.2m—enough to put many SMEs out of business, according to Snapdragon, a consultancy offering intellectual property protections.²

Similar cases are emerging against European SMEs. Toll Collect, a mid-sized German company with 600 employees, was targeted recently by such a case. It holds a government contract for a road-pricing system for trucks in Germany, with some terminals placed in neighbouring countries including the Netherlands. Toll Collect was sued by a German firm, Papst, which owns a European patent for road-pricing systems. The case was filed in the Netherlands among other places, and a Dutch court found in Papst's favour.³

Staying clear of patent trolls is not, of course, the only issue for exporters wishing to protect their markets. In many parts of the world, the issue is far simpler: enforcing the IP protections already on the books. In China, for example, "the problem is not necessarily with the legislation, but with the implementation" of IP rights, says Christoph Kaiser, managing director in China for Turck Technology, a family-owned German industrial automation company with annual sales of around €500m. Similarly, Dutch biotech firm Keygene has yet to set up a full subsidiary in China because of IP concerns. CEO Arhen van Tunen believes that IP rights for products such as his—innovative crop improvements—are weak in China. The company holds more than 500 patents, but these are only as good as local enforcement of property rights.

FINDING A WAY

Such concerns keep giant emerging markets such as China and India out of reach for many European SMEs. So, for instance, although most large Dutch companies such as Philips and ABN Amro are well established in both countries, few SMEs have followed their example. Fewer than 200 Dutch firms operate in India. A 2016 survey of Dutch companies active in China, carried out by the Dutch Ministry of Foreign Affairs,⁴ found only about 1,000 Dutch companies in the country, out of a total of 871,000 Dutch companies, most of them SMEs. "The barriers to doing business mentioned most often concern government relations and the Chinese regulatory environment," the Ministry says. "Bureaucracy and the lack of transparency in legislation are the most common hurdles."

² <https://www.snapdragon-ip.com/2016/06/29/patent-trolls-threats-smes-innovation>

³ <http://www.eplaw-patentblog.com/eplaw/2011/07/nl-toll-collect-v-papst-licensing.html>

⁴ <http://hongkong.nlconsulate.org/binaries/content/assets/postenweb/c/china/netherlands-consulate-general-in-hong-kong-sar-and-macao-sar/2016/se/business-survey-china-2016.pdf>

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Opaque rules and inconsistent application of regulations governing health products, among others, along with customs classification issues and variable VAT rules even within a single market create day-to-day problems for all exporters. These problems are felt most keenly by firms new to exporting and short on resources for figuring out the details of the regulatory, legal and tax systems in each of its export markets. Free trade agreements, along with various initiatives to reduce the paperwork burdens on exporters and cross-border investors, can help. But occasionally well-intended efforts, such as the pan-European patent filing system and the remote customs-clearance initiative, have unintended consequences that actually can increase the burden on exporters. It remains for policy makers to improve on these efforts, to avoid having newly internationalising SMEs turn back from their efforts to venture abroad.