Guidance Note on Value-Added Tax in the Extractive Industries[1]

Contents

1. INTRODUCTION

1.1. Executive Summary

In the tax structure surrounding investment in the oil, gas and mining sectors, arguably not enough systematic attention has been paid towards the role of broad-based consumption taxes and their impact on the extractives industry. The value-added tax (VAT), also commonly referred to as the goods and services tax (GST), is the broad-based consumption tax of choice in more than 160 countries worldwide, including those countries with large extractive industries.[2]

Due to their predominantly export orientated nature, governments should not expect large amounts of VAT revenue from the extractive industries operating in their country. The VAT treatment of the extractive industries could, however, be a barrier to investment which could ultimately lead to decreases in tax revenues from other taxes. There are also neutrality, efficiency and other potential costs to consider when deciding on the desired VAT system to apply to the extractive industries.

As VAT is applied to both extractive industry inputs and outputs, and also taking into account the long lead times in extractives industry investments, VAT affects the industry at every phase in the typical life cycle:

Life Cycle Phase	Key activities undertaken[3]	Input VAT Deduction	Outpu

Production	Production and commercial processing Typical 15-20+ year period	Yes	Yes Often at a zero rate as output is largely exported	Generally 0% VAT on export of outputs Recovery of input VAT Opportunity cost on cash flow Exposure to exchange rate depreciation Compliance costs for documentary requirements accompanying export
Decommissioning/ Rehabilitation	Removal of infrastructure Restoration of site	Yes	No	Surplus input VAT refunds due Opportunity cost on cash flow Exposure to exchange rate depreciation

Both the exploration and development phase require considerable direct investment, with the development phase alone often accounting for 40 percent to 50 percent of the total cost of the project.[4] Large capital goods are generally imported and other inputs are also imported or supplied by the local economy. During these periods there is no commercial production/sales of output. This means that extractive industries may have difficulty in being allowed to register for VAT and that there is little or no output VAT on domestic sales against which input VAT can be deducted. Therefore, input VAT refunds will arise that can or cannot be claimed, depending on local legislation. The refund policy of the host country thus becomes critical to investment decisions as it affects the cash flow position of the investor and could become a cost to the investor. The delay of input VAT refunds can act as a barrier to investment during the exploration and development phases.[5] Further, the adopted VAT policy applicable to the extractive industry and related administration can have spillover effects into the local economy.

[4] The United Nations Conference on Trade and Development report, available at http://unctadxiii.org/en/SessionDocument/suc2012d1_en.pdf

[5] It can also be argued that the timely refund of input VAT can create a competitive advantage to a country in relation to other potential investment countries.

for the purpose of making taxable supplies. Note that the terms input credit or VAT credit are often used to mean the same as input VAT deduction.

Input VAT apportionment: An input VAT apportionment will generally need to be made where a registered supplier acquires goods or services partly for making taxable supplies and partly not for making taxable supplies.

Output VAT: VAT charged on the supply of goods or service by a registered supplier.

Reverse-charge rule: A rule that is often applied to imported services. The recipient of the imported services would be required to self-assess the VAT on such services.

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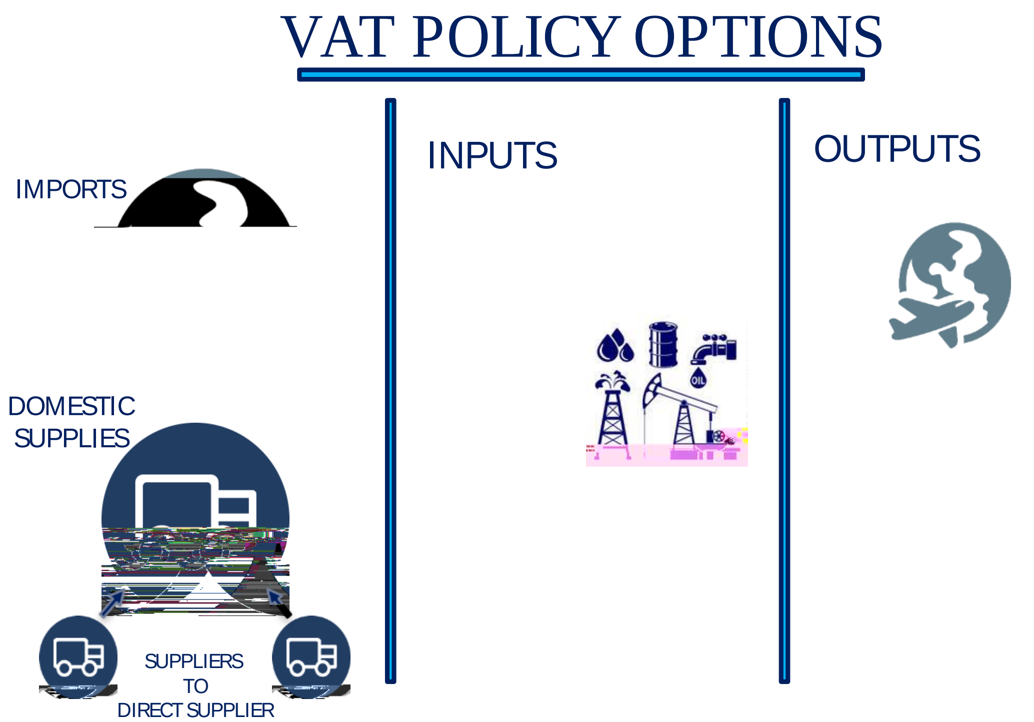
same transactions as in Table 1, but where the manufacturer makes a zero-rated supply by exporting goods.

other words, an extractive industry supplier should be viewed as having a VAT enterprise during all the life cycle phases of the business, and not only the production phase.

To enable an extractive industry supplier to deduct the input VAT and import VAT paid (and to claim a refund), the supplier should be allowed to register when its

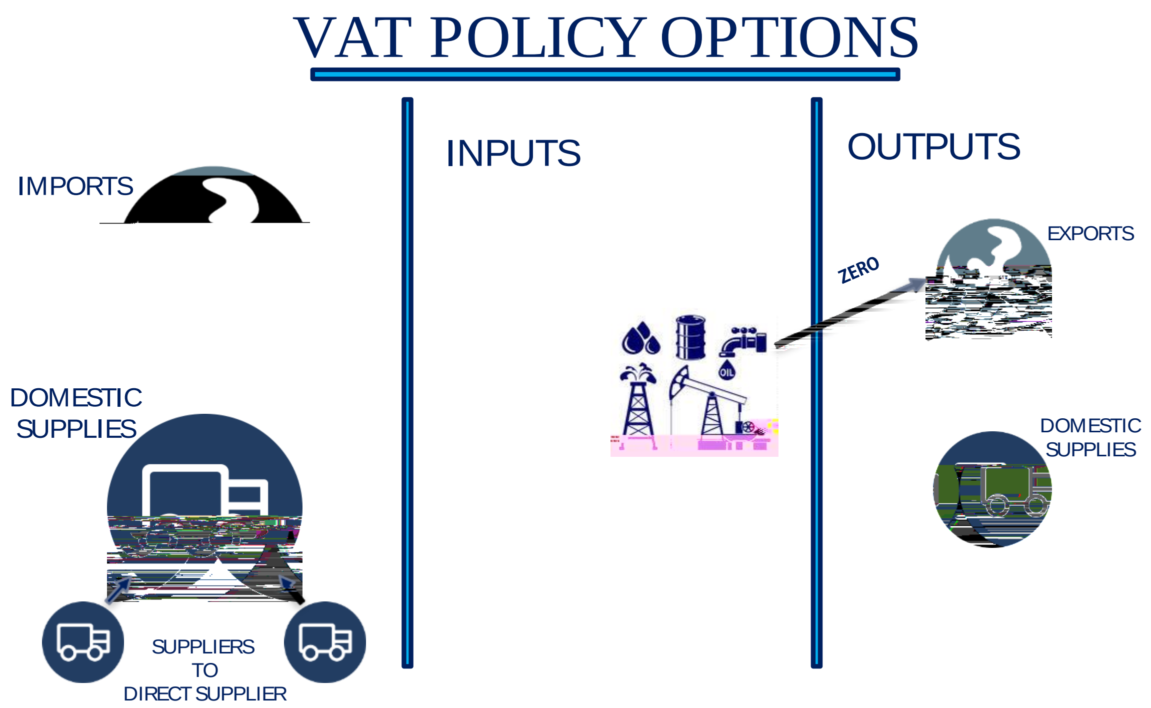


A standard rate of VAT is charged on all inputs, and corresponding outputs are charged at the standard VAT rate on domestic supplies and a zero rate on exports. Excess input VAT would be refunded at the end of the requisite period. Extractive industry suppliers would be allowed to register at the exploration phase so that the typical VAT input, output mechanism would function. This approach would ensure that domestic consumption attracts VAT whilst production, once exported would not attract VAT in that jurisdiction.

Although this best practice policy approach is ideal, unless there is a robust system that works to efficiently refund surplus input VAT, it may create cash flow issues for the extractives industry (since, as noted, the exploration and development stages do not attract output VAT whilst the production stage typically attracts zero rated VAT). The administrative requirements (specifically the timely payment of VAT refunds) in successfully implementing this approach may suggest that alternative policies may be preferable for governments and investors. These alternative policies, together with their advantages and disadvantages

2.4.2. Exempt goods and services supplied to the extractive industries

One approach to mitigate the issues regarding the timely payment of input VAT refunds is to exempt goods and services typically supplied to the extractive industry. This means that a careful selection of goods and services would be required to mitigate the risk of this exemption being used for goods and services not specific to the extractives industry. Strict audit and enforcement rules would also be required to limit the abusive use of these exemptions.



In the case of imported exempt goods m ported3310.0 1 2s1-3(s)-483(m)-665(sp)-3(o)--BT/F1 1

An issue to consider with this approach is that recovery of any input VAT would effectively be shifted towards suppliers to the extractives industry (they would ultimately be in a refund position). This means the accompanying issues in obtaining a VAT refund within a reasonable period are also shifted towards these suppliers. This would particularly occur in instances where the supplier was not making other standard-rated supplies.

In summary, the following issues are likely to arise when goods and services to the extractive industry are exempted or zero rated:

- A decrease in the neutrality and economic efficiency of the VAT due to the differentiated treatment of goods.
- An increase in administration and compliance costs of the VAT, without any additional revenue being generated.
- A decrease in total revenue, due to goods that were previously standard rated and consumed by households, now being zero rated or exempt.
- Bargaining to expand the goods that are zero rated or exempt by extractive industry suppliers, or by other industries to obtain preferential treatment.
- Increased opportunity for fraud and evasion.

2.4.4. Policies similar to selective zero rating of supplies to the extractive industry

In attempting to resolve or address issues connected to the timely payment of VAT refunds, countries may adopt policies that have a similar result to applying a selective zero rating of supplies to the extractive industry. The purpose of such policies Tm[(p)-3(o)-3(li)4R43(su)-3(c)10(h)6( )]TJBT1 0 0 90.44 4333(p)-eu17T1 0 0 1 1rT1 0 0oT

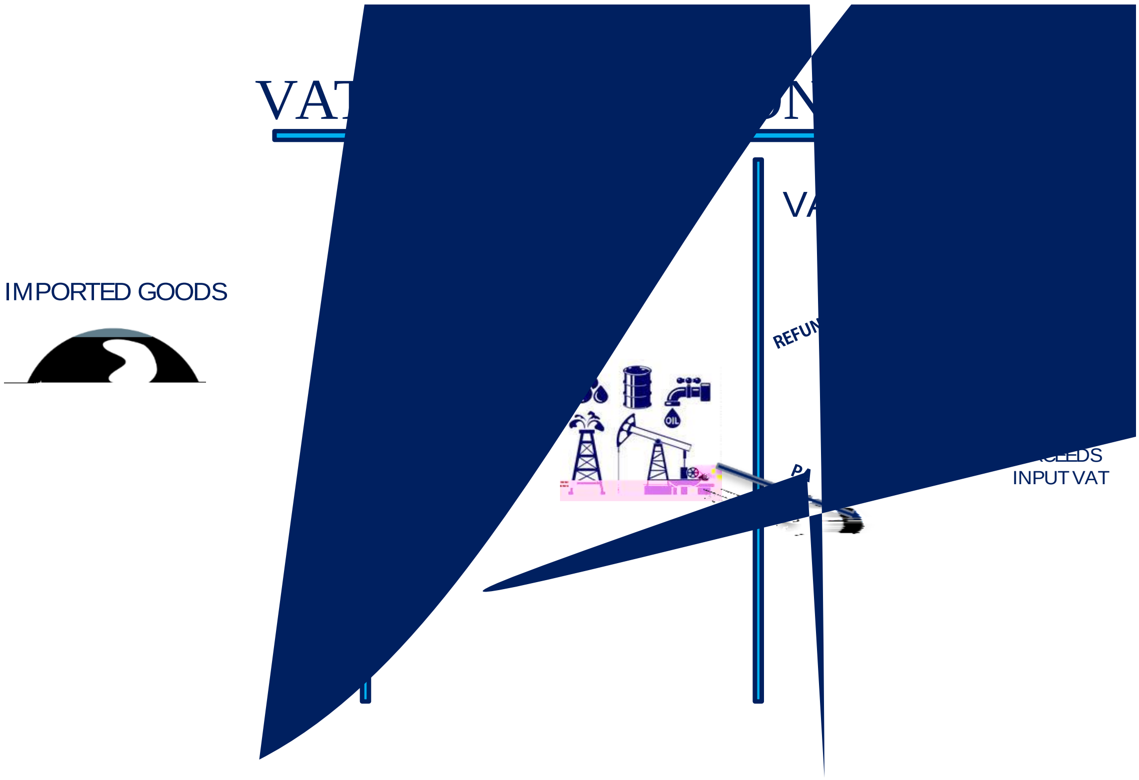
VAT POLICY OPTIONS

INPUTS

VAT PAID

IMPORTED SERVICE

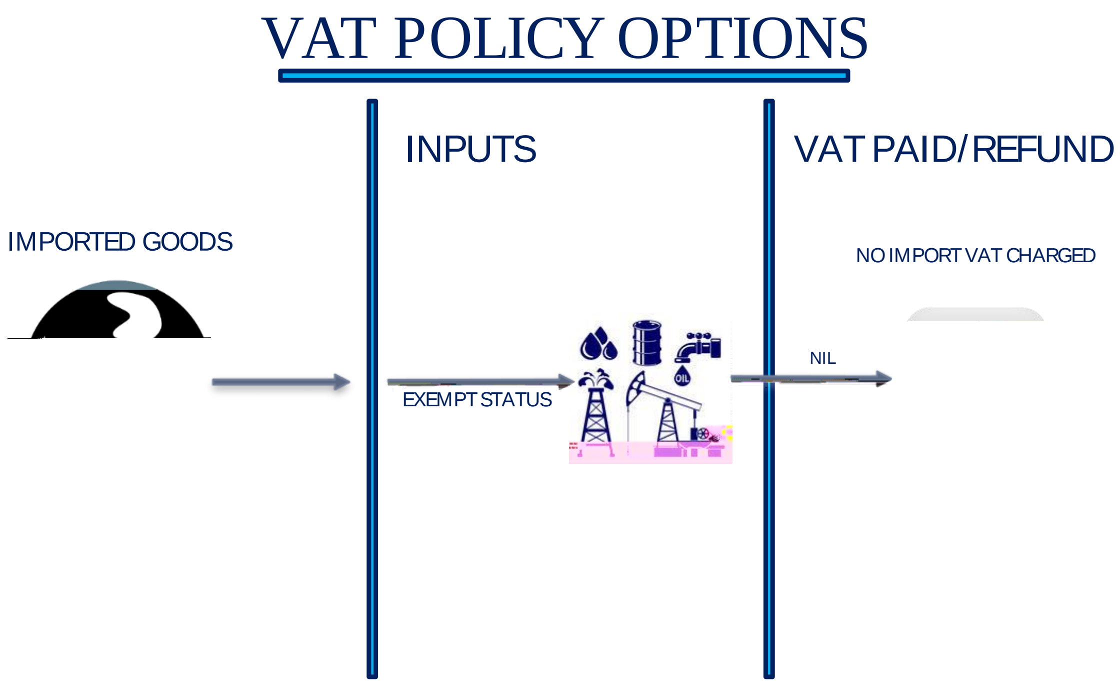
NOT USED IN ENTERPRISE



Deferral of VAT on imported goods – accounting only, no payment

Another, perhaps more preferred, method of deferral of import VAT is to require the importing supplier to simply account for the import VAT on its

. The supplier would show the import VAT as output VAT with an input VAT declaration equal to the output VAT shown on the return, meaning that a net nil VAT position would arise on the importation of goods. This approach, would however, require robust administration and liaison between domestic tax collection services and customs services. Further good tracking mechanisms would be required to ensure that only eligible items are included within the scope of this provision. It may also be possible to allow the deferral not on specific goods, but rather on s, s oy0 0 1mble sp



Pure administrative approaches for the extractive industry

It should be understood that the majority of issues regarding input VAT refunds to the extractive industry are administrative. These issues can be associated with compliance costs in claiming VAT refunds, administrative costs in auditing VAT refunds, sufficiently budgeting for VAT refunds and the physical payment of VAT refunds. Such administrative burdens could be reviewed and mitigated as follows:

- o Review of the documentation required to claim an input VAT refund as well as the time it takes suppliers to prepare and submit applications for input VAT refunds.
- o Implementing a risk based approach to VAT administration which could see targeted reviews and potentially more refunds being paid and with less delay.
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[15]) which could assist tax compliant supplier

eiving refunds in a timely manner. This could further provide an

towards increasing compliance in an

The only significant issue with

risk channeling is that the treatment of older and newer VAT suppliers may not be neutral and favor older VAT suppliers. However, this can also be an

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effective benefit to government, since new vendors will have an incentive to demonstrate their compliance with VAT requirements as soon as possible.

    - Post VAT refund audits for lower risk refund claims, such refunds can be paid more often and with less delay.

- In budgeting for input VAT refunds, refund forecasting and monitoring tools could play an important role in ensuring sufficient funds are allocated and made available to pay refunds. Such tools would forecast the expected amount of refunds that need to be budgeted for, based on patterns of past refund claims. A dedicated VAT refund account at the Central Bank of a country may also address cash flow problems faced by government in relation to paying input VAT refunds.
- Offsetting input VAT refunds against other tax liabilities.
    - It is possible to allow extractive industries to offset input VAT refunds owed against other tax liabilities. This approach would, however, require that a unified taxpayer accounting debt management system be in place.
    - It is important to note that allowing offsetting of input VAT refunds against

negative consequences of not paying VAT refunds in a timely manner.

3.
PLACE OF SUPPLY AND CONSUMPTION OF SERVICES

3.1. Issues regarding services

Applying the destination principle to services has been problematic due to difficulties in determining the place of supply and consumption of services. Before the recent growth in globalisation and technology, there was little need to establish rules relating to the place of consumption of services, as most services were consumed in the country where they were physically performed. Globalisation and technology has resulted in many different proxies used by different jurisdictions in determining the place of supply and consumption of services. These different proxies can create problems such as double taxation, non-taxation and increased administrative and

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CONCLUSION

From a developing country perspective, whilst the benefits of having a VAT mechanism in place are clear, the effects of the system not working should not be understated.

Investment decisions and cash flow could be affected and spill over on local content could also be a consequence. Whilst the extractive industry should generally not be seen as different to other industries, given its predominant export character, an efficient VAT mechanism along with supporting administration is especially important to it. An inefficient system can increase project costs and discourage investment. In particular, VAT for the extractive industry should not be seen as a revenue generation tool.

Finding the right balance between providing VAT policy and related administration that is attractive to extractive investors and also supports growth of the domestic economy would ease perceived barriers to investment. As noted, VAT revenue from the extractives industry is likely to be minimal in countries where this industry is largely export-oriented, but administration of the VAT could provide ch

Structured dialogue between government and the extractive industry could also provide for solutions to the issues discussed in this overview note that are tailored to each countr s specific context.