Attachment to Coordinator Paper: (5) Overview Note on Value-Added Tax in the Extractive Industries[1]

Contents

1. Overview

1.1. Executive Summary

In the tax structure surrounding investment in oil, gas and the mining sectors, little systematic attention has been paid towards the role of broad-based consumption taxes and their impact on the extractive industries. The value-added tax (referred to as VAT from hereafter), 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. It is generally also the broad-based consumption tax adopted by countries with large extractive industries.[2]

Due to the VAT being applied to both the inputs and the outputs of the extractive industries and

				documentary requirements ac-companying 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 to 50 percent of the total cost of the project.[3]

Large capital goods are generally imported and other inputs might be either imported or supplied by the local economy. As there is no commercial production and consequently, no sales during these periods, there is little or no output VAT on domestic sales against which input VAT can be deducted. This means that input VAT refund claims will arise which could or could not be honored, depending on local legislation

Input VAT: In the case of domestic supplies, input VAT is the VAT charged on the supply of goods and services to a vendor, which qualifies for an input VAT deduction. In the case of imported goods or services, input VAT is the VAT paid by a vendor on the importation of goods and services, which qualifies for an input VAT deduction.

If the purchasing vendor acquires the goods for use, consumption or supply in the course of making taxable supplies, the vendor will generally qualify for an input VAT deduction.

Input VAT apportionment: An input VAT apportionment will generally need to be made by a vendor if a good or service is acquired partly for the use, consumption or supply of taxable supplies and partly for non-taxable supplies (predominantly exempt supplies).

Output VAT: VAT charged on the supply of goods or service by a vendor, where the goods or services are supplied in the course or furtherance of that vendor's economic activities (also often referred to as enterprise or business).

Reverse-charge rule: A rule that is often applied to imported services. The recipients of the imported service would be required to self-assess themselves to VAT. Import VAT will therefore only be paid to the extent it cannot be offset with output VAT.

Taxable supplies: Supplies of goods or services by a vendor that are charged with VAT. This will include supplies that are charged with the standard VAT rate, a reduced VAT rate in the case of a country that applies multiple VAT rates or a zero-rated supply.

Vendor: A person that is registered or required to be registered for VAT. A person will be required to register for VAT if that person's taxable supplies exceed a compulsory threshold within a certain period (generally 12 months). In most jurisdictions a person is allowed to register for VAT even when that person's supplies do not exceed the compulsory registration threshold, subject to a voluntary threshold or other provisions.

Zero rate: A zero rate for purpose of VAT means that a vendor will be regarded as making taxable supplies in relation the supply of zero-rated goods or services, but this taxable supply is charged with VAT at nil percent. This means that such a vendor will be allowed to claim an input VAT deduction for purchases in relation to such a zero-rated supply (refer to the meaning of input VAT).

2.2.3. 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 industries. A careful selection of goods and services to be tax exempt would be required to mitigate the risk of this exemption being used for goods and services not specific to the extractive industries.

In the case of imported exempt goods or services, import VAT would already not be imposed; neither would there be input VAT on specific locally sourced goods and services. Consequently, as extractive industries would not pay input VAT on their purchases, there would be neither need nor entitlement to an input VAT deduction and under this approach, the issues regarde i 3.2(s)8S30.77(u)-04.9(b)6(

An issue to consider with this this approach is that recovery of any input VAT would effectively be shifted from the extractive industries towards the suppliers.] The suppliers would ultimately be in a refund position since they would in theory be entitled to claim refunds for their input VAT paid, but because of the zero rate applied to their supplies to the extractive industries, there would be no output VAT against which the input VAT could be credited. This would particularly occur in instances where the supplier was not making other standard-rated supplies.

2.2.5. Policies similar to selective zero rating of supplies to the extractive industries

In attempting to resolve or address issues connected to the timely payment of VAT refunds, countries may adopt policies that have a similar result as applying a selective zero rate to supplies to the extractive industries. Such policies aim at creating an effective administration of VAT so that VAT refund positions, should they arise, would not be unduly delayed. Further, such policies would be expected to limit economic distortions and possible risk of using zero-rated supplies in other industries besides the extractive industries.

VAT on imported services

imposition of import VAT. There is, however, an obvious risk of fraud in this approach from importers who falsify their proof of exempt status or import goods under the exempt status of another vendor.[7]

2.2.6. Pure administrative approaches for the extractive industries

It should be understood that the majority of issues regarding input VAT refunds to the extractive industries are of administrative nature. 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:

- Review of the documentation required to claim an input VAT refund as well as the time it takes vendors to prepare and submit applications for input VAT refunds.
- Implementing a risk based approach to VAT administration which could see targeted reviews and potentially more refunds being paid and with less delay.
    - F

Overview of VAT Mechanism Policy options – Best Practice options

Policy option	Overview	Pros

3. Place of supply and consumption of decommissioning/rehabilitation services

3.1. On overview of the issue regarding decommissioning 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. This has resulted in many different proxies used by different jurisdictions in determining the place of supply and consumption of services. These different proxies provide for problems such as double taxation, non-taxation and increased administrative and compliance burdens.

In the decommissioning phase in extractive industries, services are often supplied by vendors located in other jurisdictions. These services often involve a planning stage and an execution stage. The planning stage will generally take place at the supplying vendors' place of operation or fixed establishment. The execution stage would take place at the extractive site. The supplying 3(g)2.6(v)527(n)e0.1(m1d(n)5.3(.402 Td3-s)-4[1d

site (planning), but domestic VAT laws generally do not allow for such “majority” rules. It may, therefore, be preferred to specifically include decommissioning services as imported services in domestic VAT laws, to allow extractive industries vendors to use the reverse-charge rule (if applicable).

4. Conclusion

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

Amongst others, the industries’ investment decisions could be affected and for the host country, spill over on local content could also be a consequence. Whilst the extractive industries should generally not be seen as different to other industries, an efficient VAT mechanism along with supporting administration which works for the extractive industries would inure to investment decisions.

Host countries finding the right balance between an attempt to provide for VAT policy and related administration that is attractive to extractive investors and also supports growth of the domestic economy would ease any perceived barriers to investment. VAT revenue from the extractive industries is likely to be minimal in countries where this industry is largely export-orientated, but administration of the VAT could provide challenges for continued investment in this industry.

From a policy perspective, the ideal approach would be to apply full taxation to this industry. If the full taxation approach is not administratively feasible, deferring the import VAT on capital goods by requiring vendors to report the VAT in their following VAT return may be preferable. Generally, to protect the domestic market, exemptions or zero-rating of goods and services supplied to the extractive industries are less preferred.

From an administrative perspective, measures should be put in place to decrease the delay in paying input VAT refunds. These could include an improved risked based auditing approach and post-refund audits of low risk input VAT refunds. Further, forecasting tools can assist in ensuring sufficient revenue is allocated and available for input VAT refunds. If a taxpayer has a consolidated accounting and debt management system in place, it may also be beneficial to allow taxpayers to offset input VAT refunds against payable tax liabilities.

Structured dialogues between government and the extractive industries could also provide for solutions to the issues discussed in this overview note that are tailored to each countries specific context.

5. Appendix: Overview of the VAT

The VAT and revenue

From an economic perspective, the following two equations show the base of the VAT[10]:

(1)

Income (Y) can be divided into wages (

Production – Distribution Chain	Purchases incl. VAT	Sales incl. VAT	VAT deduction	VAT charged
Retailer	300	500	30	50
Consumer	500	0	0	0

the originally produced good. This may in turn put pressure on government to introduce additional exemptions. Besides preferences towards inputs that do not include non-deductible VAT, the destination principle (which ensures neutrality in international trade) will be compromised.

The VAT will generally also be more complex when directly taxing production, resulting in an increase in compliance and administrative costs. Particular burdensome compliance costs arise where vendors who make taxable and non-taxable supplies (meaning an input deduction is not allowed) have to apportion input VAT.

Production under the VAT can also be ta .þ(i)-3.2(n)-0. .0 Td( )T