

Distr.: General  
1 December 2016

Original: English

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**Committee of Experts on International  
Cooperation in Tax Matters  
Thirteenth Session**

New York, 5-8 December 2016

Agenda item 3 (b) (ii) of the of the provisional agenda\*

Taxation of Extractive Industries

**Proposed Guidance on Value Added Tax (VAT) issues in the  
Extractive Industries**

*Summary*

This is an updated version of the VAT guidance note presented as CRP 3, [Attachment B](#), during the 12<sup>th</sup> Session of the Committee of Experts in Geneva. The note is for further consideration and approval at the Thirteenth Session of the Committee of Experts in December, with a view to its being incorporated in the 2017 Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries. Please refer to the Twelfth Session Coordinator's report, by Committee Member Mr. Eric Mensah ([E/C.18/2016/CRP.3](#)) for an overview of the Subcommittee's work.

# Guidance Note on Value-Added Tax in the Extractive Industries<sup>1</sup>

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<sup>1</sup> This overview note was prepared by Marius van Oordt, Richard Stern and Nana Okoh with input by the Subcommittee on Extractives Industries Taxation Issues for Developing Countries.

## **1. INTRODUCTION**

### *1.1. Executive Summary*

In the tax structure surrounding investment in the oil, gas and mining sectors, 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.<sup>2</sup> Ideally, VAT in the extractive industry should not be different to any other industry and be subjected to full taxation. Developing countries with limited administrative capacity may however experience challenges in following this ideal, and may consider or have already implemented alternative policy or administrative measures.

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:

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<sup>2</sup> One exception to this generalization is the United States which has no national level broad based consumption tax, although most states have adopted retail sales taxes.

<b>Life Cycle Phase</b>	<b>Key activities undertaken<sup>3</sup></b>	<b>Input VAT Deduction</b>	<b>Output VAT Charged</b>	<b>Key Issues</b>
Exploration	<ul style="list-style-type: none"> <li>• Locating deposits</li> <li>• Assessing commercial and economic viability</li> <li>• Typical 3-10 year period</li> </ul>	Yes	No	<ul style="list-style-type: none"> <li>• Surplus input VAT refunds due</li> <li>• Opportunity cost on cash flow</li> <li>• Exposure to exchange rate depreciation</li> </ul>
Development	<ul style="list-style-type: none"> <li>• Preparation of site for production</li> <li>• Establishment of infrastructure</li> <li>• Typical 2-4 year period</li> </ul>	Yes	No	<ul style="list-style-type: none"> <li>• Surplus input VAT refunds due</li> <li>• Opportunity cost on cash flow</li> <li>• Exposure to exchange rate depreciation</li> </ul>
Production	<ul style="list-style-type: none"> <li>• Production and commercial processing</li> <li>• Typical 15-20+ year period</li> </ul>	Yes	Yes Often at a zero rate as output is largely exported	<ul style="list-style-type: none"> <li>• Generally 0% VAT on export of outputs</li> <li>• Recovery of input VAT</li> <li>• Opportunity cost on cash flow</li> <li>• Exposure to exchange rate depreciation</li> <li>• Compliance costs for documentary requirements accompanying export</li> </ul>
Decommissioning/ Rehabilitation	<ul style="list-style-type: none"> <li>• Removal of infrastructure</li> <li>• Restoration of site</li> </ul>	Yes	Limited amount and often zero rated as output and infrastructure is exported.	<ul style="list-style-type: none"> <li>• Surplus input VAT refunds due</li> <li>• Opportunity cost on cash flow</li> <li>• Exposure to exchange rate depreciation</li> </ul>

<sup>3</sup> These activities may take longer in practice than the typical period provided in this table.

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.<sup>4</sup> 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 only be claimed when registration is allowed. 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.<sup>5</sup> Further, the adopted VAT policy applicable to the extractive industry and related administration can have spillover effects into the local economy, whether positive as a result of increased economic activity or negative as a result of decreased economic activity or non-neutrality...

During the production phase, produced goods are often predominantly exported,<sup>6</sup> meaning the destination principle will apply to these exports and the supply<sup>7</sup> will be zero-rated.<sup>8</sup> Due to the majority of output being exported and therefore zero rated, the amount of output VAT against which input VAT can be deducted is limited, creating the need to obtain refunds of input VAT from the government. During this phase, the delay of input VAT refunds could create VAT policy and related administration challenges and be a barrier to investment.

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<sup>4</sup> The United Nations Conference on Trade and Development report, available at [http://unctad.xiii.org/en/SessionDocument/suc2012d1\\_en.pdf](http://unctad.xiii.org/en/SessionDocument/suc2012d1_en.pdf)

<sup>5</sup> 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.

<sup>6</sup> It should be noted that this is not always the case, e.g. in the case of gas in Brazil.

<sup>7</sup> VAT is usually described as being imposed on “supplies” rather than “sales” of goods or services, since the term “supplies” includes sales as well as other forms of providing goods and services to a customer (refer to terms used).

<sup>8</sup> All countries with a VAT apply the destination principle. The destination principle ensures neutrality in trade and protects the legal base of the VAT (consumption). It involves zero rating exported goods and services and applying an import VAT to imported goods and services.

During the decommissioning/rehabilitation phase, services that relate to decommissioning are often supplied by businesses in a different jurisdiction than the extractive site. This is as a result of the expert nature of these services often not being obtainable in the country of the extractive site. Since production has ceased and generally little supplies are made during this phase, challenges regarding the refund of input VAT may again arise. This is so as there is no output VAT against which input VAT (primarily on services) can be claimed, and extractive industries may be required to deregister for VAT before completing the decommissioning/rehabilitation phase.

From an extractives industry perspective, the key issues to note therefore relate to:

- A stable, neutral and efficient VAT framework applicable to the industry.
- The timely recovery of input VAT, to i) mitigate opportunity costs on cash flow and ii) protect against exchange rate depreciation which would erode the value of the refunds due.
- Being allowed to register before making any taxable supplies and not being forced to deregister during the decommissioning/rehabilitation phase.
- Efficiency regarding the administrative requirements when exporting goods.

From a host country perspective, the key issues to note would relate to:

- A stable, neutral and efficient VAT framework which would ensure that VAT refunds due are administered in a timely manner and minimize distortions.
- Demonstrating that the host country is a suitable location for long term, stable investments.
- Developing the local economy as a result of the increased investment in the country.
- A robust set of rules relating to the tax treatment of decommissioning.
- Limiting evasion under the VAT to the extent it applies to the extractive industry and industries supplying to this industry.

## *1.2. Purpose*

The purpose of this note is to provide an overview of VAT policy and administration measures that countries have implemented or could consider as they relate to the life cycle of the typical extractive industry activities. The potential impact on investment decisions and spillover effects into the local economy are also discussed. Place of supply and consumption rules, as they relate to the extractive industry, are also suggested.

## *1.3. Status of the note*

This note is for information purposes only. It is intended to identify VAT issues related to the extractives industries and identify and discuss all potential policy and administrative initiatives that countries have implemented or could consider implementing. It should be understood that the discussion of a policy or administrative initiative does not mean that this initiative is recommended. On the contrary, some initiatives are not recommended, but discussed since some countries have implemented these initiatives and other may consider doing so in the future.

## *1.4. Meaning of terms used*

**Exemption:** An exemption means that no VAT is charged on a supply of goods and services and no input VAT deduction can be claimed.

**Full taxation:** Full taxation in relation to VAT means that a single rate is applied to all goods and services in the economy, i.e. there are no exemptions, zero ratings (except for exported supplies), reduced ratings or other alternative policies applicable to the VAT.

**Import VAT:** VAT paid by a recipient of imported goods or services. Import VAT is generally paid to a customs or similar office on the importation of goods and to a branch of the revenue services or postal office on the importation of services.

**Input VAT:** VAT charged on a supply of goods or services to a purchaser, where the VAT may be deducted or reclaimed by the purchaser. The VAT will in most cases be deductible if the purchaser is registered for VAT and acquires the goods or services

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.

**Supply:** The term supply has a wider meaning than the term sale and also includes for example rental agreements, installment credit agreements, involuntary disposals and compulsory disposals.

**Taxable supplies:** Supplies of goods or services by a registered supplier 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.

**Registered supplier:** A person that is registered or required to be registered for VAT.

**Zero rate:** A zero rate for purpose of VAT means that a supply will be charged with VAT at zero percent and a registered supplier would remain entitled to an input VAT deduction.



## 2.

**VAT POLICY AND ADMINISTRATION IN THE EXTRACTIVE INDUSTRY***2.1. An overview of the VAT*

The VAT is a tax on final consumption of goods and services charged on value-added at multiple stages of production. Table 1 illustrates this process:

**Table 1: Workings of a VAT (assume a rate of 10 percent)**

<b>a. Basic transactions, excluding VAT</b>		
<b>Production-distribution chain</b>	<b>Purchases</b>	<b>Sales</b>
Producer	0	4,000
Manufacturer	4,000	12,000
Wholesaler	12,000	14,000
Retailer	14,000	20,000
Consumer	20,000	-
<b>b. VAT payments to suppliers and buyers</b>		
<b>Production-distribution chain</b>	<b>VAT paid to supplier</b>	<b>VAT paid by buyer</b>
Producer	0	400
Manufacturer	400	1200
Wholesaler	1200	1400
Retailer	1400	2000
Consumer	2000	-
<b>c. Fractional collection of VAT paid by consumer</b>		
<b>Distribution-production chain</b>	<b>Tax paid to supplier</b>	<b>Tax paid to government</b>
Consumer	2000	-
Retailer	1400	600
Wholesaler	1200	200
Manufacturer	400	800
Producer	0	400

Adjusted from Cnossen, S (2009), "A VAT primer for lawyers, economists, and accountants", *Tax Notes* 124(7), 687-98.

From Table 1 it can be seen that the total value added in the production-distribution chain (20 000) multiplied by the tax rate (10 percent) is equal to the net amount received by government (2 000), which is paid by the consumer. This amount is however collected from registered businesses in the production-distribution chain based on their value-added. This is achieved by having registered suppliers charge output VAT on their supplies and allowing registered purchasers an input VAT deduction of the tax paid to the supplier. The tax is therefore not borne by registered businesses since the tax paid by them to their suppliers is either deducted or refunded (where their input VAT deductions exceed their output VAT charged).

An input VAT deduction is, however, only allowed if the registered purchaser will use the goods or services purchased to make taxable supplies, e.g. supplies that are charged with VAT. Since a consumer is a final recipient of the product (i.e. it does not make taxable supplies), no input VAT can be deducted by the consumer and the consumer pays all the tax. The consumer, as opposed to a producer, paying the VAT is central to ensuring the neutrality and economic efficiency<sup>9</sup> of the VAT.

A key feature of all VAT systems is the destination principle, which ensures neutrality in trade and protects the legal base of VAT. Neutrality in trade can be taken to mean that foreign businesses are not advantaged or disadvantaged in respect of the level of VAT applied to a supply of goods or services in a jurisdiction. In essence, the destination principle allows for VAT only being collected in the country of consumption of goods and services. This is achieved by zero rating exports and charging import VAT on imports. Table 2 illustrates the workings of the same transactions as in Table 1, but where the manufacturer makes a zero-rated supply by exporting goods.

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<sup>9</sup> For this purpose, economic efficiency means that the VAT does not influence the behaviour and decisions of producers.

**Table 2: Workings of a VAT with a zero rated supply**

<b>a. Basic transactions, excluding VAT</b>		
<b>Production-distribution chain</b>	<b>Purchases</b>	<b>Sales</b>
Producer	0	4,000
Manufacturer	4,000	12,000
<b>b. VAT payments to suppliers and buyers</b>		
<b>Production-distribution chain</b>	<b>VAT paid to supplier</b>	<b>VAT paid by buyer</b>
Producer	0	400
Manufacturer	400	0 (in country of origin)
<b>c. Fractional collection of VAT paid by consumer</b>		
<b>Distribution-production chain</b>	<b>Tax paid to supplier</b>	<b>Tax paid to (tax refunded by) government</b>
Manufacturer	400	(400)
Producer	0	400

From Table 2 it can be seen that as a result of exporting the goods or services, the government receives no VAT revenue (400 – 400). It is further important to see that this will only be the case where the manufacturer is allowed to deduct input VAT on the VAT paid to the producer (400). Where the manufacturer makes other standard rated taxable supplies, this input VAT can be offset against those supplies. If, however, the manufacturer does not have sufficient supplies against which to offset the input VAT, the government needs to provide the manufacturer with a VAT refund. Failure to do so, or do so in a timely manner, results in many distortions (discussed later) and incorrectly taxes production rather than consumption.<sup>10</sup>

## 2.2. VAT registration

Due to the extensive periods during the exploration, development and decommissioning/rehabilitation phases that extractive industries often do not make taxable supplies, registration issues may arise. Many countries impose a voluntary

<sup>10</sup> If a government does not plan on providing input VAT refunds to extractive industry suppliers, it should make that clear during negotiations. It should further understand that this is entirely inconsistent with the nature of a VAT and creates an entirely different type of cost.

registration threshold, requiring suppliers to make taxable supplies in excess of a certain amount within generally a 12 month period before being able to register. There may also be other requirements that need to be met before allowing a supplier to register for VAT. Further, when a supplier no longer makes a sufficient amount<sup>11</sup> of taxable supplies, that supplier may be required to deregister.

It is important to note that an extractive industries supplier should be considered to be conducting a VAT enterprise from when, and for as long as, that supplier is involved in the activities of the enterprise. The classification as a "VAT enterprise" should not be artificially limited only to periods when it is making taxable supplies. In 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 activities relating to the extractive industries commence (exploration phase) and should not be deregistered until after its activities cease. This means that the decommissioning/rehabilitation phase should be considered an integral part of the exploration venture, and the supplier should only be made to deregister after this phase is complete. Not doing so might result in an investor not being able to claim VAT refunds, or only being able to claim a VAT refund at a much later stage.

### *2.3. Issues relating to VAT policy and administration in the extractive industry*

As a result of the destination principle, VAT should in theory have little impact on the extractives industry since its supplies are generally exported. Further, due to the industry's export orientation, government should not expect to raise much VAT revenue from this sector, as revenue is typically raised on domestic consumption. A government's revenue generation from the VAT is therefore limited to the amount of product consumed domestically. However, it is notable that in practice, challenges with VAT remain, as explained in this note, in particular in relation to refunds.

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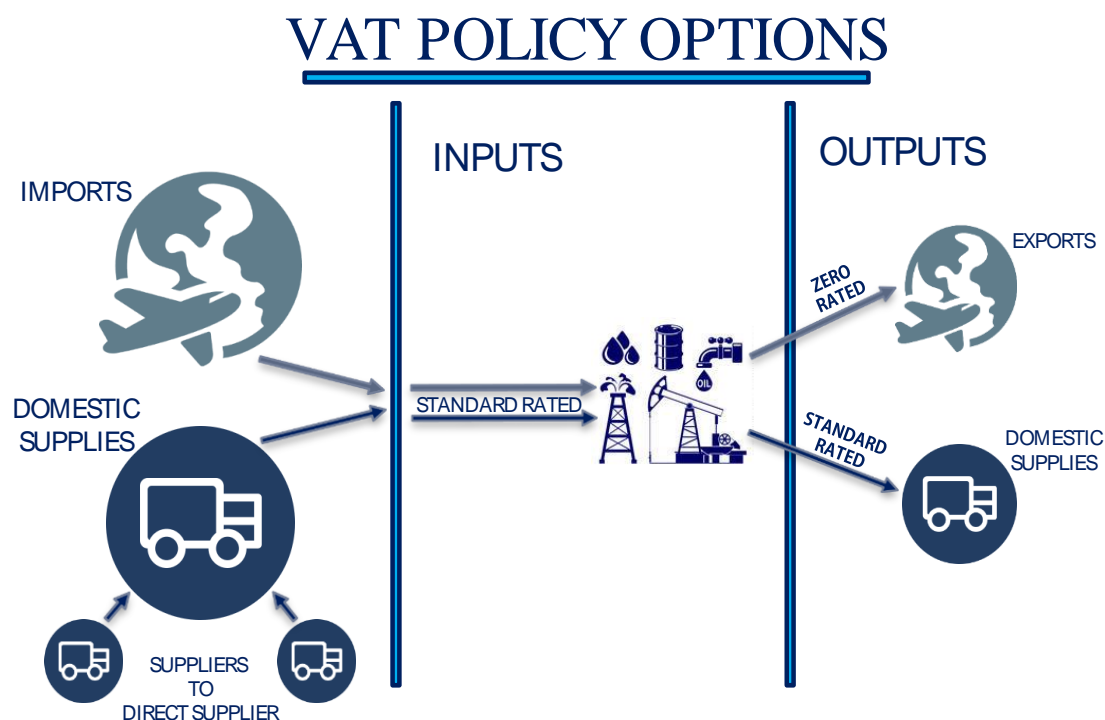
<sup>11</sup> This is generally the amount of the voluntary registration threshold.

The exploration and development stages do pose particular challenges for VAT. There is significant capital and other investment (input VAT including reverse charge on imports) but little or no production (output VAT) hence this ultimately creates a surplus input VAT position which if not refunded in a timely fashion will impact cash flow, foreign exchange fluctuations and associated investment decisions, ultimately affecting local content.<sup>12</sup>

#### 2.4. VAT policy and administration options relating to the extractive industries

##### 2.4.1. Full application of VAT

Ideally, a VAT policy for the extractive industry should not be any different from any other industry. The key focus should be an efficient and robust VAT framework which favors government as well as the investor and does not leave the investor or government in a position where funds are locked up:



A standard rate of VAT is charged on all inputs, and corresponding outputs are charged

<sup>12</sup> This is of course an issue in other industries besides the extractive industries.

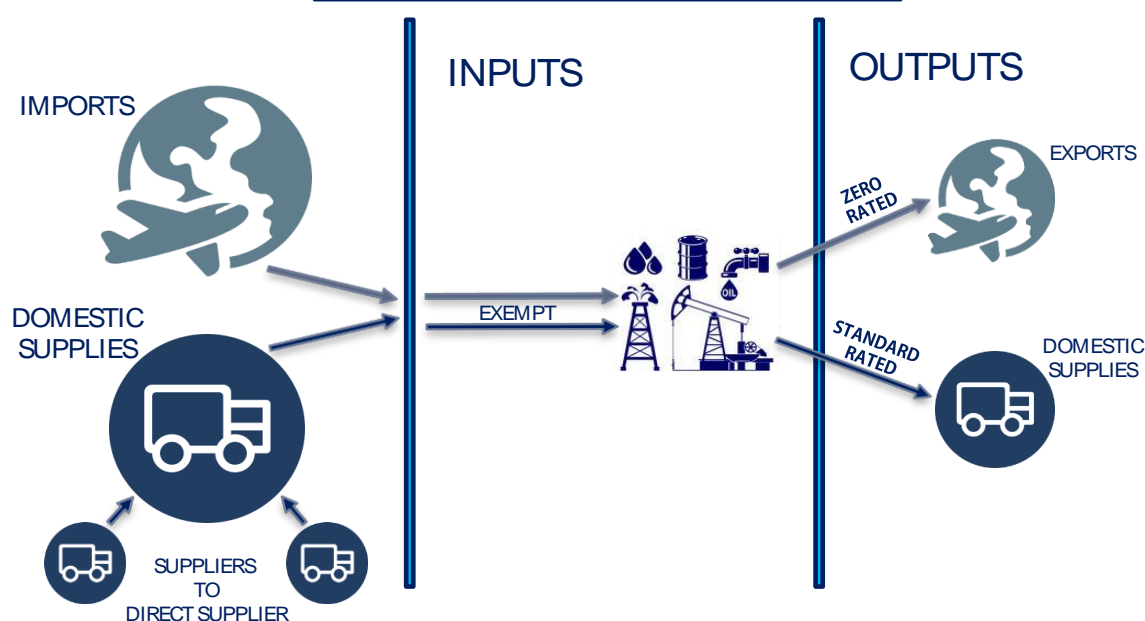
at the standard VAT rate on domestic supplies and a zero rate on exports. Excess input VAT would be refunded at the end of the requisite period. Extractive industry suppliers would be allowed to register at the exploration phase so that the typical VAT input, output mechanism would function. This approach 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. 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 are discussed in the remainder of this subsection.

#### 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.

## VAT POLICY OPTIONS

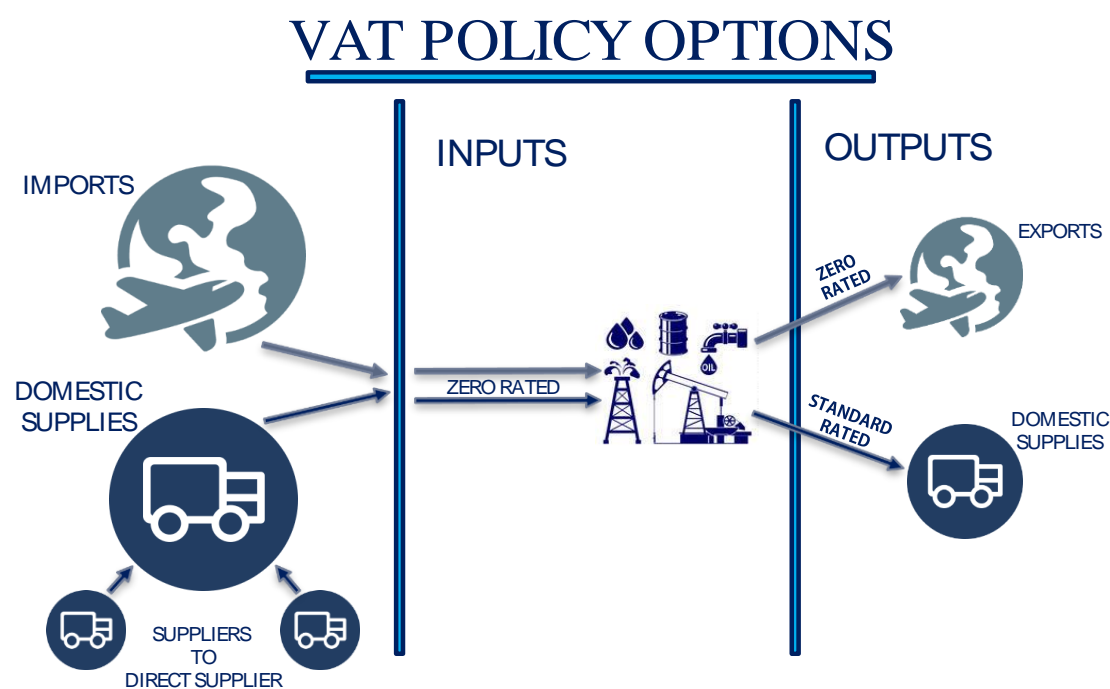


In the case of imported exempt goods or services, import VAT would not be imposed meaning no entitlement to an input VAT deduction. Further, there would not be input VAT on specific locally sourced goods. Although the issues regarding the timely payment of input VAT refunds should, with this approach, be largely resolved,<sup>13</sup> it should be noted that a full VAT exemption regime could result in economic distortions. Local suppliers to the extractives would continue to have input VAT on their inputs which they would not be able to fully offset by charging output VAT on their supplies to the extractives industry. This may result in local suppliers attempting to pass such irrecoverable costs to the extractive industries. There would also be a theoretical risk of creating a pro-import bias in the sense that supplies imported free of VAT could ultimately be cheaper than local supplies with inflated prices. Such a consequence could negatively impact the local economy outside of the extractive industry.

<sup>13</sup> It may be that there are certain types of goods or services used by many industries that are standard-rated and an input VAT refund may still potentially arise. It can, however, be expected that this refund would be significantly less.

Compliance burdens for local suppliers would further increase to the extent that they would be required to distinguish between exempt supplies and standard rated supplies. The local supplier would then be required to do an input VAT apportionment, which may give rise to significant compliance costs to the local supplier. The non-neutrality and non-symmetrical compliance burden, and accompanying economic distortions that results because of implementing the exemption is most likely to exceed the benefit of resolving the refund problem.

### 2.4.3. Zero rate goods and services supplied to the extractive industry



Another approach to avoid the issues regarding the timely payment of input VAT refunds is to zero rate the goods and services predominantly supplied to the extractive industry. Similar to the exemption regime discussed in subsection 2.4.2, there is a high risk, especially in less developed economies, that the zero-rated goods and services would in practice not be used only by the extractive industry. This risk is likely to be higher under this option, when compared to the exemption regime, since locally sourced goods and services of these types would not be subjected to any VAT.



An issue to consider under 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:

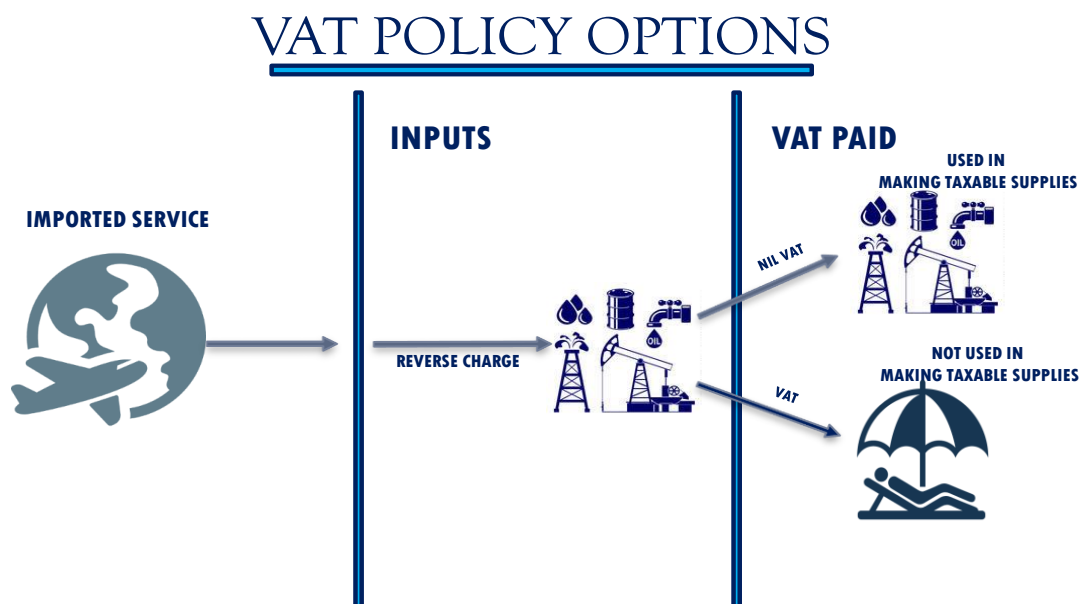
- A decrease in the neutrality and economic efficiency of the VAT due to the differentiated treatment of goods.
- Non-symmetrical compliance burdens between local registered businesses and extractive industry suppliers.
- An increase in administration and compliance costs of the VAT, without any additional 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 in the form of accounting measures that have a similar result to applying a selective zero rating of supplies to the extractive industry.<sup>14</sup> The purpose of such policies would be to promote the effective administration of VAT such 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 industry.

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<sup>14</sup> All the approaches discussed below are currently implemented by at least one country in Europe.

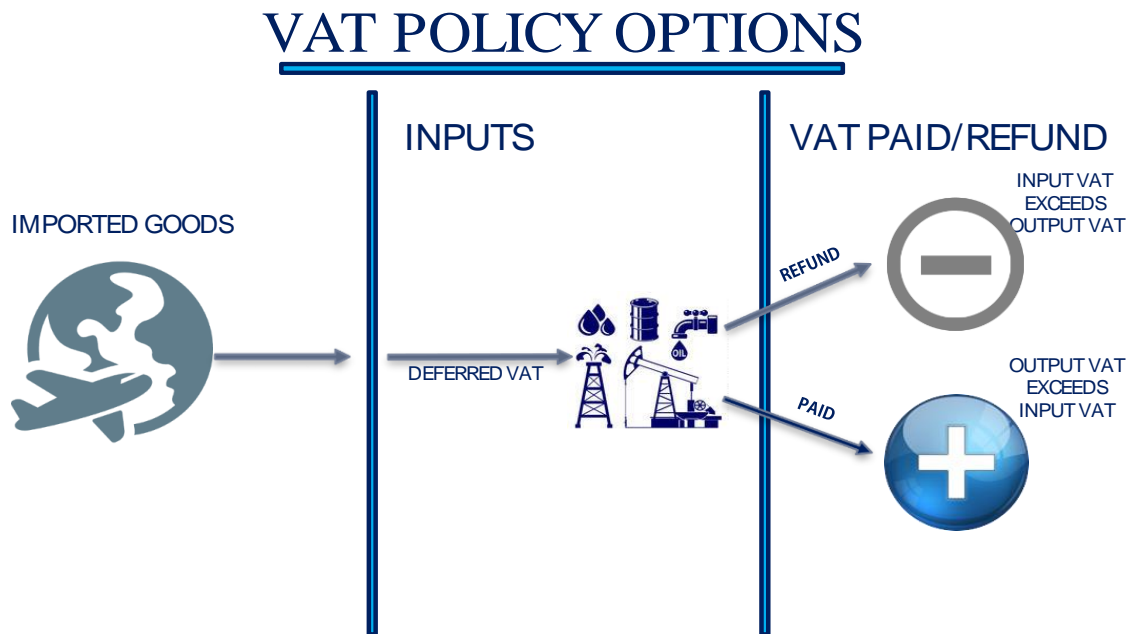
*VAT on imported services – application of the reverse charge*

The reverse charge could be applied to import services whereby the requirement to pay and later request a refund could be lifted. The extractives industry would be required to self-assess the amount of import VAT that needs to be paid. Similar approaches can be applied to the importation of goods.

*Deferral of VAT on imported goods – payment time lag*

This would allow deferral of payment of import VAT for a specific period of time by not requiring import VAT upon importation, but a payment of output VAT in a later VAT return. The aim of this approach is to allow registered suppliers to make taxable supplies from the use or supply of the imported goods for a limited time before ultimately being accountable to pay the VAT, thereby easing cash flow constraints. Ideally, this mechanism allow registered suppliers to charge output VAT and then account for the VAT on imports. It should, however, be noted that where the taxable supplies of the importer are zero-rated (as would often be the case in the extractive industry due to exporting their supplies), there would be no output VAT against which the input VAT deduction can be claimed and the issues regarding the timely payment

of VAT refunds would remain. Further, if the period of deferral is too short, these issues would also remain.

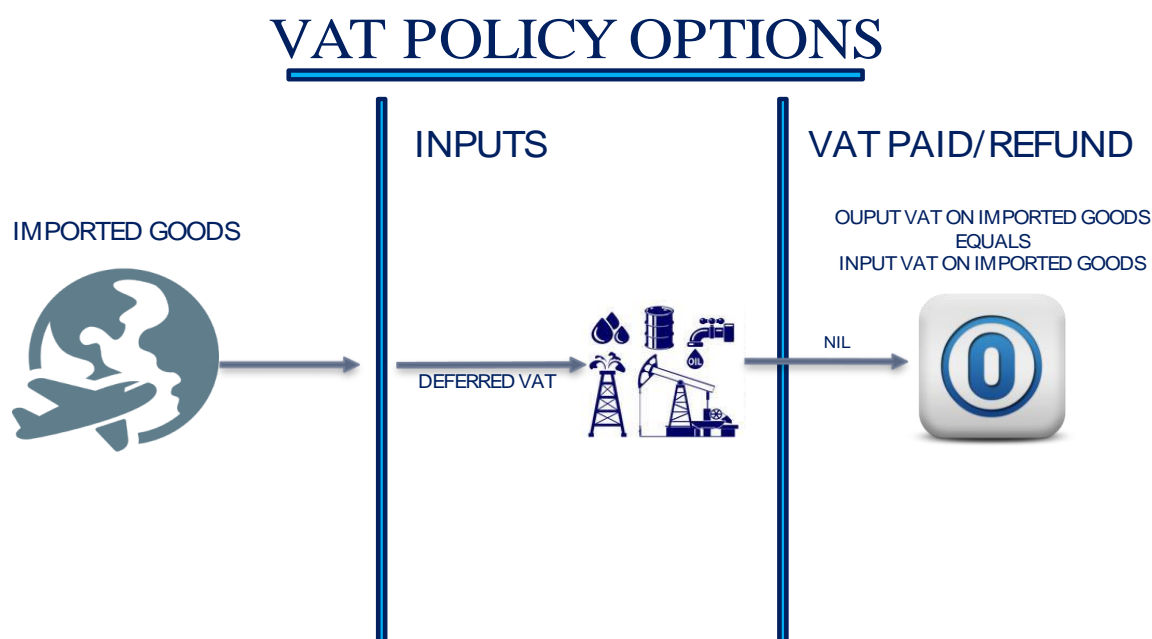


*Deferral of VAT on imported goods – accounting only, no payment<sup>15</sup>*

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 VAT returns as an 'in' and 'out'. The supplier would show the import VAT as output VAT with an immediate input VAT deduction for 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, and therefore might only be suitable for experienced tax administrations. 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

<sup>15</sup> This approach is currently adopted by the European Union for all supplies of goods between countries in the Union.

possible to allow the deferral not on specific goods, but rather on all goods imported by a specific entity.<sup>16</sup>

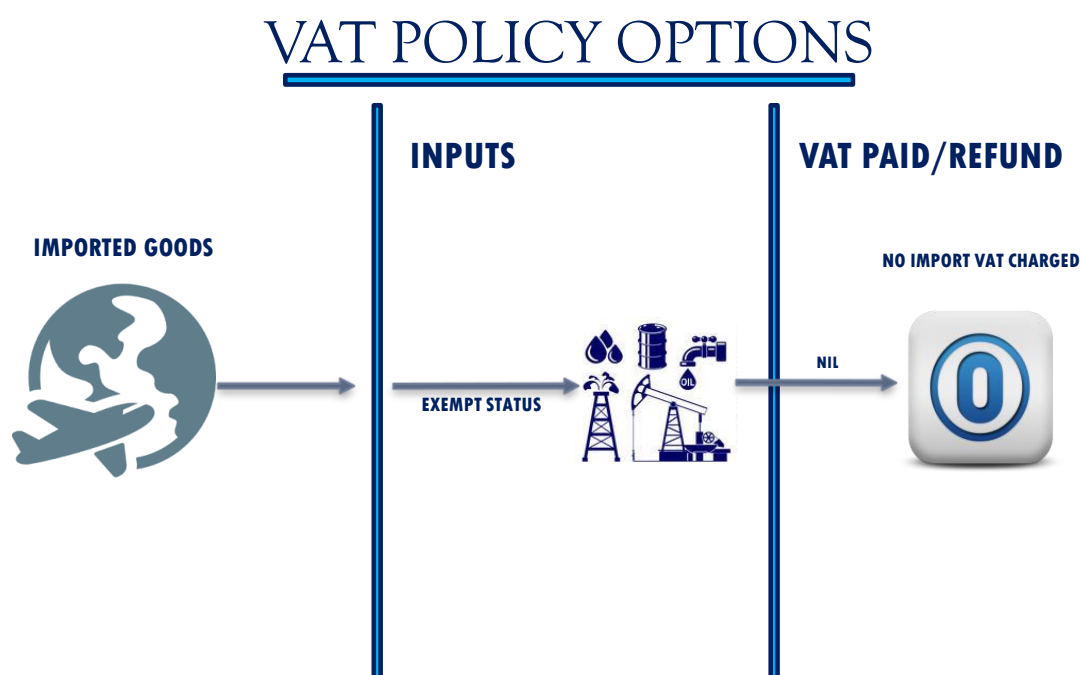


### *Exempt status to the extractive industry suppliers*

It would also be possible to provide exempt status in relation to certain imported goods to suppliers in the extractive industry. This approach is therefore different to the one discussed in section 2.4.2 as it does not involve a change in legislation. Upon the importation of those specific goods, a supplier would provide proof of its exempt status to the customs office to relieve the 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 supplier.<sup>17</sup>

<sup>16</sup> It should be noted that for temporary importation of goods, typically for temporary extractive industry missions, alternative approaches may be preferred to defer the import VAT.

<sup>17</sup> Similar risks of evasion that are present under a retail sales tax could arise under this approach. Goods may be removed from the VAT chain and it may be difficult to track this type of fraud.



### 2.5. 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. If a country has the administrative capacity to resolve the issues arising from VAT refunds by administrative (rather than policy or accounting) measures, the following administrative approaches could be implemented:

- 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 and attempt to decrease these documentary requirements. The risk of fraud should also be considered in this process.
- Implementing a risk based approach to VAT administration which could see targeted audits and potentially more refunds being paid and with less delay.

- Following a risk channeling approach (often referred to as a “green and red channel” approach<sup>18</sup>) which could assist tax compliant suppliers (“green channel”) receiving refunds in a timely manner. This could further provide an incentive for “red channel” taxpayers towards increasing compliance in an attempt to be moved to the “green channel”. 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 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 other debts besides tax liabilities owed to government may provide for significant administrative challenges. Further, input VAT refunds should not be offset against future tax liabilities which cannot be accurately established.

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<sup>18</sup> This is also sometimes referred to as the “gold and silver status” approach.

- Ensure that there are extractive industry taxation experts within the general tax administration unit. Not fragmenting extractive industry administration allows for harmonized and consolidating procedures in terms of risk management, assessment, payment, appeals and collection, while still recognizing and addressing unique issues of the extractive industries.

### **Country Examples**

#### **Ghana**

In 2008 Ghana introduced an administrative measure called the VAT Relief Purchase Order (VRPO), applicable only to the extractive industry. Extractive companies could issue VRPOs instead of paying VAT for certain goods which were specific to the industry. The VRPO system effectively resolved the refund issue for these goods and is similar to providing an exempt status to the extractive industry for these goods.

The VRPO system however requires additional monitoring to ensure it is not misused. To manage fraud under this system, the Ghanaian tax authority promptly withdraws eligibility to use VRPOs whenever any misuse arises.

The Ghanaian tax authorities have stated that they will in due course withdraw the use of VRPOs. This is as a result of systematic and fundamental changes made to the VAT refund system which allows quick and efficient processing of refund claims, so the VRPO system is no longer required.

#### **Democratic Republic of Congo**

In 2016 the Government of Congo directed that VAT refunds should no longer be paid in an attempt to reduce pressure on the domestic currency. This has seen a significant growth in the amount of refunds due to the extractive industries. In an attempt to decrease the growth in refunds owed, the country temporarily exempted imported goods to the mining industry. This instability in the tax system could have long term repercussions on investment, which could decrease the value of the domestic currency.

**Zambia**

In 2014, due to strict export documentary requirements, a large amount of refunds due by the Zambian Government accumulated. The Chamber of Mines of Zambia appealed in a media statement to the government to refund VAT owed to mines. According to this statement failure to pay VAT refunds would force the already cash-constrained mining industry to cut back on capital projects, lower production, make suppliers wait longer for their money, interrupt certain corporate social investment projects and diminish the collection of revenue by the Zambia Revenue Authority. This serves as an example of the often unforeseen distortions and negative consequences of not paying VAT refunds in a timely manner.



## Overview of VAT Mechanism Policy and Accounting Options

Policy option	Overview	Pros	Cons
<b>Full Application of VAT</b>	<ul style="list-style-type: none"> <li>• Standard rate VAT on inputs</li> <li>• Standard/Zero rated VAT on outputs</li> </ul>	<ul style="list-style-type: none"> <li>• Cyclical flow of VAT funds – no distortion in the VAT Chain</li> </ul>	<ul style="list-style-type: none"> <li>• Opportunity cost on cash locked up in refund positions for suppliers.</li> <li>• Suppliers exposed to exchange rate depreciation</li> </ul>
<b>VAT exemption regime</b>	<ul style="list-style-type: none"> <li>• No VAT charged on inputs or outputs</li> </ul>	<ul style="list-style-type: none"> <li>• No refund situations arise to the extractives industry</li> </ul>	<ul style="list-style-type: none"> <li>• Distorts VAT chain. Supplier in lower end of the chain would not be allowed an input VAT deduction.</li> <li>• Close monitoring of supplies within/out of scope required by tax administrations.</li> </ul>
<b>Zero rated supplies to the extractives industry</b>	<ul style="list-style-type: none"> <li>• Supplies specific to the extractives industry to be zero rated</li> </ul>	<ul style="list-style-type: none"> <li>• No refund situations arise to the extractives industry</li> </ul>	<ul style="list-style-type: none"> <li>• Distorts VAT chain. Supplier in lower end of the chain likely to be affected by surplus input VAT position.</li> <li>• Close monitoring of supplies within/out of scope required by tax administrations.</li> </ul>
<b>VAT on imported services – application of the reverse charge</b>	<ul style="list-style-type: none"> <li>• Only pay VAT to the extent of not making taxable supplies</li> </ul>	<ul style="list-style-type: none"> <li>• Cyclical flow of VAT funds – no distortion in the VAT Chain</li> <li>• Ease on cash flow of suppliers</li> </ul>	<ul style="list-style-type: none"> <li>• Decreased cash flow to Government, even in the short term– affect forecasting and planning</li> </ul>
<b>Deferral of VAT on imported goods – payment time lag</b>	<ul style="list-style-type: none"> <li>• Payment only due once taxable supply is made by the extractives.</li> </ul>	<ul style="list-style-type: none"> <li>• Cyclical flow of VAT funds – no distortion in the VAT Chain</li> </ul>	<ul style="list-style-type: none"> <li>• Refund issues remain for suppliers if insufficient output VAT is generated</li> <li>• No cash flow to Government, even in the short term– affect forecasting and planning</li> </ul>

<b>Deferral of VAT on imported goods – accounting only, no payment</b>	<ul style="list-style-type: none"><li>• Account for VAT on statutory returns only</li></ul>	<ul style="list-style-type: none"><li>• Ease on cash flow of suppliers</li></ul>	<ul style="list-style-type: none"><li>• Requires close monitoring: mitigate fraud risk by administrations.</li></ul>
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### **3. PLACE OF SUPPLY AND CONSUMPTION AS APPLICABLE TO THE EXTRACTIVE INDUSTRIES**

Registered businesses in the extractive industry often make use of service suppliers located in other jurisdictions than the extractive site. Further, an extractive site can be located off shore and outside the scope of a countries VAT. This sections considers these issues and how to potentially treat them for VAT purposes.

#### *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 compliance burdens.

In the extractive industries, services are often supplied by suppliers located in other jurisdictions. It is therefore important to determine the place of supply and consumption of these services.

#### *3.2. General rules relating to the place of consumption of services*

To avoid double or non-taxation for the supply of inter-jurisdictional services, taxing rights are granted to a jurisdiction. This generally means that the services will be exported services and zero-rated in other jurisdictions and charged with VAT in the jurisdiction which holds the taxing rights. Of course, it is first necessary to determine whether a supply of services is inter-jurisdictional before determining taxing rights.

The OECD has set out guidelines that apply the destination principle to internationally traded services.<sup>19</sup> These guidelines as they relate to business-to-business supplies are:

- For consumption tax purposes, internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption.
- The jurisdiction in which the customer is located has the taxing rights over internationally traded services or intangibles.
- The identity of the customer is normally determined by reference to the business agreement.
- When the customer has establishments in more than one jurisdiction, the taxing rights accrue to the jurisdiction(s) where the establishment(s) using the service or intangible is (are) located.

It should be noted that the aim of these guidelines is to allocate the taxing rights to ensure that the value-added by these services is taxed in the jurisdiction where the goods and services that ultimately arise as a result of the supply of services, will be consumed.

### *3.3. Place of supply of services*

A further issue is the place of supply of services. Services could either be supplied in another jurisdiction and, therefore, be imported services subject to import VAT or be supplied in the same jurisdiction as the extractive site and, therefore, potentially be subject to output VAT.

Whether the services supplied are imported or domestically provided could also be important for the extractive industry, especially if the reverse-charge rule to imported services is applied. If the reverse-charge rule applies to imported services, the extractive industry supplier may well prefer that the services be regarded as imported services. In the case where the services are regarded as domestically supplied, the

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<sup>19</sup> Refer to the OECD International VAT/GST Guidelines. Available at: <http://www.oecd.org/tax/consumption/international-vat-gst-guidelines.pdf>

extractive industry supplier would be entitled to an input VAT deduction on these services and issues regarding the timely payment of input VAT refunds may arise.

The place of supply is also of importance to the supplier. Generally, if the place of supply of services is in another jurisdiction to that of the supplier, that supplier may be required to register for VAT in the other jurisdiction. This would of course result in a large compliance cost for the supplier.

Based on the above, it may be preferred to allow services provided to the extractive industries from other jurisdictions to be treated as imported services.

#### *3.4. Place of consumption and supply of decommissioning/rehabilitation services*

Services supplied during the decommissioning/rehabilitation phase often provide particular place of consumption and supply issues as these services are supplied in multiple jurisdictions. These services often involve a planning stage and an execution stage. The planning stage will generally take place at the supplier's place of operation or fixed establishment often in a different jurisdiction to the extractive site. The execution stage would take place at the extractive site.

With reference to the general rules in section 3.2, it is evident that the jurisdiction in which the extractive site is located will have the taxing rights for decommissioning/rehabilitation purposes. Although the customer may have establishments in more than one jurisdiction, the taxing right should accrue to the jurisdiction where the decommissioning/rehabilitation will take place (where the applicable extractive site is located). Due to the service possibly being supplied in two jurisdictions, it may be preferred to treat the entire service as an imported service.

#### *3.5. Place of consumption and supply of offshore extractive activities out of the scope of the VAT<sup>20</sup>*

Some extractive industry activities may be performed outside of the territory of a country and therefore that country's VAT scope.<sup>21</sup> Goods may be imported or locally purchased to be used at an offshore site outside of the scope of a country's VAT and

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<sup>20</sup> If the extractive site is situated within the scope of the VAT then no special consideration is required.

<sup>21</sup> This is generally 12 nautical miles from the shore of a country.

there may also be services supplied at this offshore site. Some goods may also be moved in and out of the scope of a country's VAT, within a short time period.

Once goods are removed beyond the scope of a country's VAT, the removal of such goods would constitute an exported supply and be zero rated. If goods are imported and thereafter exported to an offshore site situated outside of the scope of a country's VAT, the issue of VAT refunds may again arise and a country may consider the policy and administrative approaches discussed in section 2 in this regard. This would also be the case where goods move in and out of the VAT scope within a short time period.

For services physically performed at the offshore site which is outside of the scope of a country's VAT, the place of supply of the services will not be in any country. The place of consumption of the services would depend on whether the supply of services are directly connected with immovable property situated at the offshore site. If this is the case, the place of consumption would be at the offshore site and no country would have taxing rights on the service supplied.

Where the supply of services are not directly connected with immovable property situated at the offshore site, the place of consumption of the services may be argued to be within the country that the customer is located (the extractive industry's onshore establishment). The services will therefore be imported services and the reverse-charge rule should be applied to these services.<sup>22</sup>

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<sup>22</sup> Refer to the OECD International VAT/GST Guidelines for further discussion regarding the place of consumption of interjurisdictional services.

#### **4. 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 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 suppliers to report the VAT in their following VAT return may be preferable. Generally, to protect the domestic market, exemption or zero-rating of goods and services supplied to the extractive industry is 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 risk 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 accounting and debt management system is in place, it may also be beneficial to allow taxpayers to offset input VAT refunds against other tax liabilities.

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 country's specific context.