ANNEX C to E/C.18/2024/CRP.10

Paper for discussion by the Tax Committee from the Subcommittee on Indirect Tax Issues

AN INTRODUCTION TO VAT/GST Refunds

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1. Introduction

Refunds are a reality of a value added tax[1]. The extent to which a country's VAT policy and resultant legislation provides for the offsetting of expenses (including capital and operational expenses) against sales income (including both zero rated and standard rated sales) will be evident in the extent of legitimate refunds claimed by taxpayers.

Refunds pose an inherent risk to revenue collections, which can only be mitigated by a range of risk mitigating interventions that should be undertaken by tax administrations; on the other hand, legitimate businesses who have submitted valid refund claims rely on the prompt payment of such refunds which if delayed, may have a devastating impact on their very existence. Striking a balance between these 2 competing realities for tax administrations is an ever-present challenge which is exacerbated by the ever-increasing reality of fraudulent refund claims.

This paper considers refunds from the perspective of both tax administrations and taxpayers. It provides an overview of the reasons for the existence of refunds and discusses the various factors that should be taken into account in the administration thereof[2]. Due to the number of papers that have been published on this particular topic, this paper does not intend to repeat what has already been published. It is therefore strongly recommended that these papers are read. (For ease of reference, see footnote 2.)

A key feature in a VAT/GST system is that the tax is intended to be borne by the end consumer, and to a limited extent by VAT-registered businesses, where both the policy intent and enabling legislative provisions provide for exemptions and/or limitations on input tax deductions. Further to this, an integral part of an efficient VAT system is the use of VAT-registered businesses to collect VAT from consumers[3] and paying such VAT to the tax administration.

Based on the fundamental principle of neutrality, VAT should not be a cost in business-to-business transactions[4]. Just as the VAT received from customers is not income earned by the VAT registered business (because it must be paid to the revenue administration) (see footnote 6), so too the VAT reported to the revenue administration in respect of a business-to-business transaction is not tax 'revenue' because it must be repaid to the business customer through a deduction against its output tax liability. Where that deduction results in a negative amount, the revenue administration is generally obligated to pay a refund.

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[1] The terms "value added tax" and "VAT" are used to refer to any national tax by whatever name or acronym it is known such as Goods and Services Tax (GST) that embodies the basic features of a value added tax, i.e. a broad-based tax on final consumption collected from, but in principle not borne by, businesses through a staged collection process, whatever method is used for determining the tax liability (e.g. invoice-credit method or subtraction method). Home | OECD iLibrary (oecd-ilibrary.org)

[2] How to Manage Value-Added Tax Refunds in: IMF How To Notes Volume 2021 Issue 004 (2021)
How to Combat Value-Added Tax Refund Fraud (imf.org)
VAT Refunds: A Review of Country Experience; Graham Harrison and Russell Krelove; IMF Working Paper 05/218; November 1, 2005

[3] VAT may be separately added to (VAT-exclusive) prices at the time of sale or factored into (VAT-inclusive) prices. It may also be legally imposed on businesses (the commonest approach) or imposed on customers but with a collection responsibility imposed on businesses (less common). Whichever approaches are taken, the tax fraction of the money collected by the business is not part of its income from the sale because the business is required to pass the VAT proportion of the price to the revenue administration.

[4] Home | OECD iLibrary (oecd-ilibrary.org)

It follows that any VAT borne by a VAT registered business (the taxpayer) that is in excess of the VAT collected in respect of sales made by that taxpayer, will result in a credit (i.e. refund) due to the taxpayer. The prompt and full cash/electronic payment of VAT refunds is necessary to ensure that the VAT achieves its intended purpose of taxing final consumption. Where the VAT is not refunded at all, businesses may have to resort to recovering such unrecovered VAT from its customers where the business cannot afford to fund such VAT cost from its profits. In addition, in those instances where the VAT refund is delayed, businesses who incur expenses until such time that the VAT has been refunded (for example, interest charges) may recover such additional costs in the form of an increase in the price of the goods or services supplied to customers.

The VAT Value Chain (VVC)

The VVC encompasses the core functions undertaken by a tax administration when administering a VAT. Set out below are the various elements of the VVC and the proposed minimum activities that are required to be undertaken by tax administrations with particular reference to the risks posed by the processing of refund claims.

I. VAT registration is a high-risk activity. It is the first engagement that a tax administration will have with potential taxpayers who have requested to register for VAT. It is essential that the information requested to be provided by the taxpayer when applying to register can be verified, preferably through 3rd party data sources, to improve the likelihood of legitimate taxpayers being registered and thereby being given access to claim VAT[5] incurred.

   The following information should at a minimum be requested at the time of application:

   - The full name and date of birth (DOB) of the natural person and the national ID card number (if applicable – not applicable if legal entity);
   - The name of the legal entity and full name and DOB of the natural person legally representing the legal entity (if applicable – not applicable if natural person);
   - Postal and registration address + name and contact details (email address + telephone number) of a contact person for the tax administration as well as and all relevant tax reference numbers of the owners/shareholders;
   - Website of the business entity (if applicable);
   - The sector in which the business activities fall e.g. agriculture, construction etc.;
   - Date of commencement of activity;
   - The date that it is liable to register for VAT;
   - Bank account details
   - Any reference number with another regulated authority (if applicable);
   - Turnover during three previous years (if applicable – not applicable for new businesses);
   - The value of expected sales to be made in a predetermined period e.g. 12 months from date of registration, alternatively the value of sales made in a prior period that requires a VAT registration;

[5] 'Pay-only registrations' – a regime that provides for a registered VAT person to only declare the VAT on sales made in a particular jurisdiction. In this regime, the VAT incurred on any expenses incurred in the particular jurisdiction is not allowed as a deduction. This regime is prevalent in jurisdictions that require non resident suppliers of goods and services to register and account for VAT on sales made to customers in that jurisdiction.

- Expected percentage of exempt activities (if applicable);
- Expected application of reduced VAT rates (Y/N and which ones).

Consideration may be given to reducing the documentary requirements required at registration for small and micro enterprises in an attempt to ease the burden for such businesses.

It is proposed that taxpayers are compelled to update their registered particulars within a specific time of any changes being made so that taxpayers can be contacted when necessary.

Depending on the relevant legislative provisions, VAT registration applications may also require in-depth evaluation to determine whether the applicant qualifies to register. Where the application is successful, the tax administration should notify the taxpayer and such notice should at a minimum, contain the VAT reference number as well as the effective date of registration.

II. The electronic filing of VAT returns allows tax administrations to continuously monitor non-compliance at an individual taxpayer level and to promptly react when non-compliance is identified e.g. non filing of returns / non-payment of the VAT liability as reported on the relevant taxpayer's VAT return. The data obtained from the submission of VAT returns should be continuously analysed in order to provide in depth insights into *inter alia,* sectoral trends and the attendant risks and opportunities to revenue collection as well as taxpayer compliance behaviour. These insights should then be used as input into the risk identification process. The analysis will also provide insights into sales and purchases trends per sector over the years.

Valuable data insights pertaining to refunds in particular include -

- The value of refund claims made per period
- The value of claims processed per period
- The value of sales (for all rates of VAT) per period
- The value of expenses per period
- The value of import VAT as a % of VAT deducted
- The trend of local standard rated sales vs expenses deducted as reflected in relevant VAT returns. In this instance, one would be able to identify whether the VAT on expenses is in line with the VAT on sales declared by all VAT registered taxpayers. Where these 2 data points do not align, further investigation should take place to understand the reasons behind such deviation; the rational being that VAT declared on sales by one taxpayer is deducted by those taxpayers who are entitled to do so. It must be borne in mind that exemptions and input tax denials would result in the VAT on sales and expenses not aligning.

III. The prompt identification of risk e.g. fraudulent refund claims, fraudulent schemes, the over or invalid deduction of VAT incurred on expenses and/or under declaration of VAT due is crucial in protecting revenue. In order to improve the likelihood of correctly identifying taxpayer's returns that may pose a risk, it is recommended that the risk identification methodology is continuously updated with new identified risks. It is also recommended that taxpayers who are in a constant refund position e.g. exporters are validated for a specific period of time – such validation will then ensure that the affected taxpayers are not continuously identified as posing a risk whenever a refund return is submitted.

It is furthermore recommended that the risk identification processes and the relevant algorithms /thresholds etc remain classified and limited to a small number of resources to limit the possibility of such rules being leaked. Once the cases are identified as posing a possible risk, the decision must then be taken regarding the type of enforcement action to be followed.

IV. VAT deregistration may be regarded by some tax administrations as not being a core function, particularly where resource constraints are prevalent. Furthermore, the deregistration process may not result in additional revenue being collected. Tax administrations with limited resources may therefore be inclined to ignore this function in favour of better utilising resources in revenue generating activities. It is recommended that regular monitoring of the VAT register is undertaken to identify those registrants who are continuously non-compliant (i.e. continuous outstanding returns or incorrect submission of nil returns) as opposed to those registrants who no longer meet the requirements of being registered, the latter having been confirmed by 3rd party data. It is therefore only in the latter case that registrants should be deregistered.

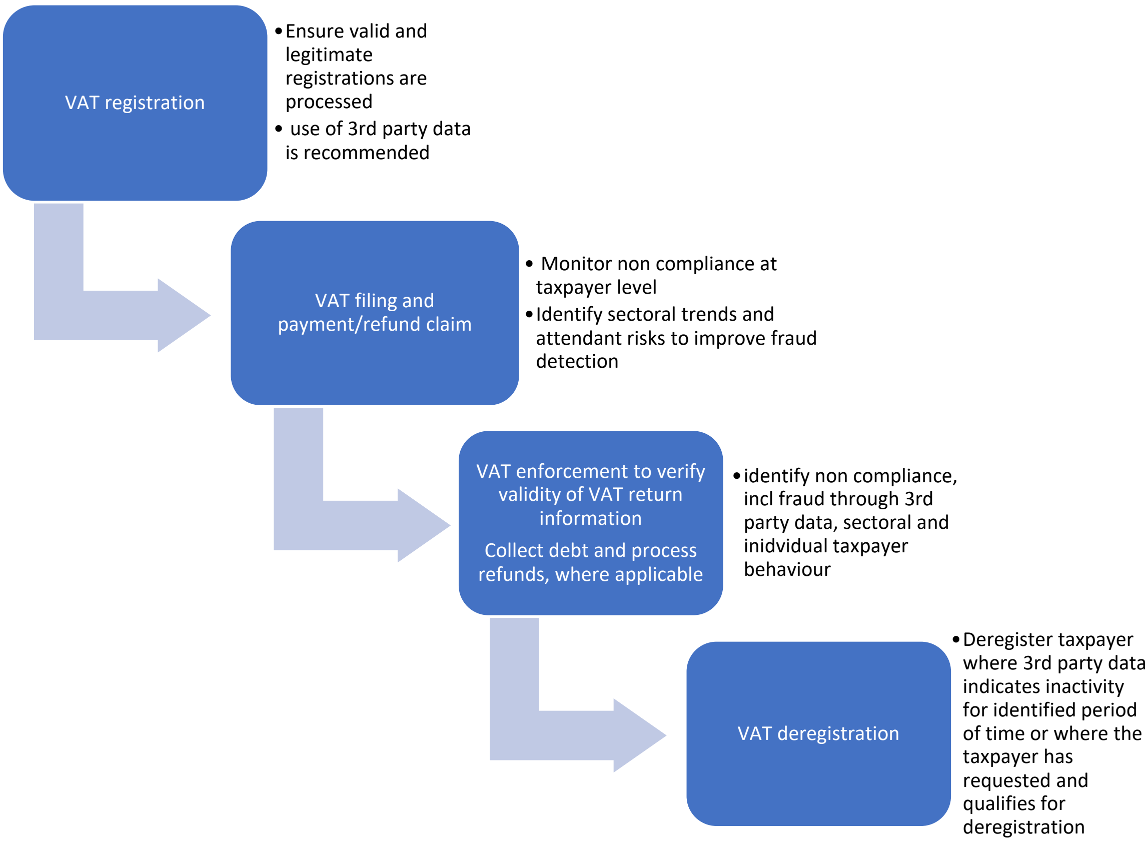

Figure 1 The VAT Value Chain

The reality of fraud[6]

For a refund mechanism to be credible, the tax administration must ensure that it is equipped with the strategies, processes, and abilities needed to identify VAT refund fraud. It must also be prepared to act quickly to combat such fraud/schemes[7]

Whilst a VAT is premised on the principle that refunds are paid timeously, the reality of fraudulent refund claims as well as the claiming of input tax deductions/credits to which the registered business is not entitled that result in a refund claim, is a constant reality and burden faced by tax administrations. Balancing the efficient and timeous processing of refunds with the risk of refunding fraudulent and non-qualifying refunds is a difficult balancing act for tax administrations. Insufficient resources to identify possible non-compliance or suspicious refund claims, high claim volumes, financial constraints, and a lack of data capacity and capability are a few of the factors that negatively impact the timeous payment of refunds.

A balancing act

Despite all these obstacles, the implementation of a VAT requires tax administrations to develop solutions to timeously process refunds (where the legislative provisions allow for such) so as to ensure that the VAT achieves its intended purpose of taxing final consumption. Failure by tax administrations to timeously pay refunds without drastically increasing the compliance burden for taxpayers claiming such refunds continues, for the most part, to be an elusive goal. What is however crucial (and beneficial) to both taxpayers and tax administrations is to ensure that refunds are timeously paid, which may have a positive impact on increasing the likelihood of business sustainability and continuity, and ultimately result in additional tax revenue being collected.

The Impact on business

Businesses experiencing cash flow constraints would depend on the prompt refunding of refund claims in order to assist such business in remaining operational; The non or late payment of refunds may also result in businesses requesting temporary credit facilities from financial institutions and thereby incurring additional expenses such as interest and overdraft fees. Such additional expenses may be the final death knell for already struggling cash strapped businesses.

Processing of refund claims

There are various mechanisms utilised by tax authorities to process a claim submitted by a taxpayer or other person who is entitled to a refund. These include –

I. The cash (or electronic) payment of the full value of the refund within a specified time;
II. The partial or full offsetting of refunds against a taxpayer's other outstanding or future tax liabilities;
III. delayed payment of the refund;
IV. the issuing of government bonds or tax certificates in lieu of refunds that are due.

[6] r-de-la-feria_a-schoeman.zp103860.pdf (up.ac.za)
[7] How to Manage Value-Added Tax Refunds (imf.org)

The electronic payment of qualifying refunds into the registered banking account of the taxpayer is obviously preferred by taxpayers. Similarly, the non-payment of refunds as well as the offsetting of refunds in future tax periods is not recommended both in terms of the overall VAT design and also due to the negative impact that such non-payment has on the registered business.

2. The reality of the existence of refunds in a VAT

In order to determine its VAT liability, a taxpayer is generally required to submit a VAT return on predetermined dates, for a specific period, indicating at a minimum, the value of its standard and zero-rated sales and the VAT that is due in respect thereof. The taxpayer is also entitled to deduct the VAT incurred on qualifying purchases. Where the VAT collected exceeds the VAT incurred, the taxpayer is required to submit its return and pay such VAT to the tax authority within the requisite time. Conversely, where the VAT incurred exceeds the VAT collected, the taxpayer will submit a return reflecting the refund that is due to it.

Factors that give rise to refunds

- Exports

In line with the principle that VAT is a consumption tax due in the jurisdiction of consumption, it follows that exports should be zero rated (i.e. in accordance with the destination principle) whilst imports should be taxed at the standard rate.

A VAT refund would arise where exporters incur local standard rated VAT when purchasing goods and services required to produce the exported goods or services. As there would be zero VAT levied on the exported sales, the VAT incurred should qualify for an input tax deduction, which will result in the exporter claiming a refund from the tax administration.

- Zero rating local consumption

The rationale for zero rating the local supply of goods and services is generally based on the principle that such goods qualify as 'merit goods' and as such are deserving of a different VAT rate. Studies have however shown that the zero rating of local supplies benefits the more affluent in society due to the fact that there are higher levels of consumption by this sector of society. [8]

It is recommended that the policy rationale for zero rating locally consumed goods and services is reconsidered with a view to identifying whether the original policy intent is being achieved and whether there are viable alternative options that would better achieve the original policy intent.

- Capital expenditure

Newly established businesses will generally incur capital expenditure which may in all likelihood be incurred prior to any income being earned or which may exceed any income that has already been earned. In addition, established businesses may incur capital expenditure due for example to expansion or replacement of capital goods. Capital expenditure may also extend to the importation of goods. The VAT on such expenditure should be allowed as a deduction,

[8] REDI3x3 Working paper 3

together with the VAT incurred on importation, and where such VAT exceeds the taxable income earned, a refund will be due to the taxpayer for the particular period.

- Seasonal expenditure

VAT refunds may occur at certain times during the year when the VAT incurred on expenses exceeds the VAT collected on sales. Common examples include stock purchases and the importation of goods for future high trading periods. Farmers and other primary producers also tend to have seasonal imbalances between high revenue tax periods and high expenditure tax periods.

- Multiple rates

Multiple rates present compliance challenges for both tax administrations and taxpayers alike. the imposition of VAT at a higher rate on the acquisition of goods/services that are ultimately used to produce goods/services that qualify to be supplied at a reduced rate, would likely result in the taxpayer submitting a refund claim.

- A refund scheme for tourists

In this instance, in line with the consumption principle, and where legislative provision is made for such dispensation, the VAT incurred on goods purchased and subsequently exported by the purchaser to a country of destination, may result in a claim for the refund of VAT incurred by the tourist. The refunding of such VAT, may, depending on the refund mechanism, fall outside the standard process provided to registered taxpayers. In this instance, it is recommended that such claims are budgeted for and subject to relevant risk processes.

- Refunds to non-established businesses as well as diplomatic missions

The refunding of VAT incurred by non-resident/established businesses and diplomatic missions is dependent on whether legislative provision is made for such claims. The likely impact of such refunds on the forecasted refunds value should take these claims into account, particularly where such claims fall outside of the standard refund process. It is recommended that adequate risk mitigation and identification of fraudulent schemes is implemented for this sector to minimise the risk of invalid refund claims being processed.

It is likely that the value of the VAT incurred by non-resident businesses would not be material when compared to that of local businesses, coupled with the fact that the destination principle should result in minimal VAT being levied on supplies made to the non-resident. Examples of VAT being incurred by non-resident businesses would be hotel accommodation and transport.

3. Mechanisms to request refunds

a. There are various processes that have been implemented by jurisdictions for taxpayers and VAT refund claimants to request a refund of the VAT incurred. These include the submission of -

   i. a VAT return reflecting the refund due
   ii. a specific form, other than the registered taxpayer's VAT return
   iii. a letter requesting the refund addressed to the relevant department of the tax administration

b. Submission of supporting documents

There may also be instances where the claim for the refund must be accompanied by the relevant qualifying documents substantiating the VAT incurred. In the event that the tax administration does not always review the documents that are required to be submitted, it is recommended that such requirement be reconsidered. The removal of the mandatory submission of qualifying documents would positively impact taxpayers as there would be a reduction in the taxpayer's compliance burden.

Tax administrations may request specific documentation in the event that the refund claim has been identified for audit. In this instance, it is recommended that the request for documentation should be specific to the risk being identified and be limited, as far as possible, to a reasonable amount of information to be provided. General and vague requests for information impose an unnecessary burden on taxpayers and furthermore, if not used by the tax administration, can be regarded as an effective use of both taxpayer and tax administration resources.

The manual submission of documents, as opposed to the digital transfer of documents to the tax administration, presents a risk due to the likelihood of the documents being lost or destroyed after they have been submitted to the tax administration. It is therefore recommended that tax administrations issue and receive all documentation electronically, the obvious benefit being that there is an automated audit trail of all correspondence.

4. Budgeting for refunds to be paid in a fiscal year

Tax administrations and any other relevant government departments (where applicable) should forecast the expected refund claims and payments to be processed and paid for all months in a fiscal year. Such forecasting is essential to ensure sufficient cashflow management for the payment of qualifying refunds. In addition, the forecasting of refunds, as well as the actual payment thereof, is also crucial in determining the net revenue collections for specific monthly periods and the applicable fiscal year.

A country's VAT refund level (in percent of gross VAT collections) is influenced by a number of factors, including (1) the nature of the economy (e.g., extent to which investment generates excess VAT credits, value-added of export industries, and proportion of taxable and zero-rated sales in the economy); (2) the design of the VAT system, particularly the extent of zero-rating and use of multiple rates; (3) taxpayer compliance behavior and extent of VAT fraud; and (4) the system and culture of the tax administration (e.g., level of corruption, capacity to detect and prevent VAT fraud, and commitment to taxpayer service in meeting statutory payment deadlines).

Everything else equal, the level of VAT refunds is likely to be higher in countries with more open and faster-growing economies (i.e. where there are higher export and investment shares in total economic activity), as well as in countries with modern tax systems and administration that apply self-assessment procedures and respect taxpayers' rights, including minimizing tax compliance costs. Conversely, refunds will be lower where countries have adopted specific schemes to reduce the number and size of refund claims—these schemes include such measures as zero-rating supplies to exporters, and deferring VAT liabilities on imported capital equipment. Finally, refund levels will also be lower in countries where tax administrations and treasuries deny refund claims during periods of government cash shortages. [9]

The IMF has developed a model that provides an approximation of the reasonable level of refunds that should be paid within a specific period.[10] This model is an excellent starting point for tax administrations (and relevant government departments).

5. Tax Administration - Reasons for refunds not being paid timeously or not being paid at all

a. Cash flow limitations

The deduction of VAT incurred by a taxpayer, which may result in a refund due to the taxpayer, can present cash flow difficulties to tax administrations. Inadequate budgeting for the payment of qualifying refunds and/or a shortage of tax revenue to process the qualifying refund are realities that are faced by tax administrations.

b. Refunds below a certain threshold (de minimis rule)

To reduce the cost of administration, tax administrations may elect not to process refunds below a certain threshold. Such refunds should then be offset against future VAT liabilities.

c. Resource constraints

The inherent risks associated with refunds may lead administrations to delay refunds, particularly if the tax administration has inadequate resources, including skilled personnel, to establish an effective risk identification and management process.

The identification of risk and the tax administration's appetite for paying refunds without first auditing the claims, have an inevitable impact on the time within which refunds are processed.

d. Low compliance levels

Provision may be made for the non -payment of refunds where the taxpayer is non-compliant in respect of its VAT and/or other tax obligations. In this instance, depending on the legislative provisions, interest on the outstanding refund may not be payable on the outstanding refund.

The view may be held that the payment of refunds to non-compliant taxpayers would not encourage the regularisation of non-compliance. On the other hand, the non-payment of refunds, where such refund is legitimately due, may have dire consequences for the taxpayer. Consideration should therefore be given to the most appropriate course of action to be taken by tax administrations which may include taxpayer education and compliance improvement initiatives.

e. Invalid taxpayer details on register

A tax administration may be unable to effect payment of a refund into a taxpayer's designated bank account if the details provided by the taxpayer are incorrect. In this instance, it is recommended that taxpayers are afforded various opportunities through designated channels

[9] VAT Refunds: A Review of Country Experience (imf.org)
[10] TPAF: VAT (imf.org)

offered by the tax administration to amend/update their registered particulars, together with the necessary supporting documentation and third-party validation, to enable tax administrations to effect the payment of the refund.

f. Time limitation to submit refund claims / deduct input tax

One of the mechanisms for managing the claiming and payment of a refunds is to prescribe the time period within which the refund claim must be submitted.

Whilst revenue authorities require a degree of certainty in projecting the value of their refunds to be paid in current and future periods, it is recommended that a balance is struck between the period that provides taxpayers to submit their refund claims and the certainty that tax administrators require.

In addition, legislative provisions may provide for limiting the time within which a taxpayer may deduct VAT incurred. Possible considerations include limiting the period to align with the corporate income tax prescription period or determining a period that is either in excess of or less than the aforementioned period; the reason being that expenses deducted for corporate income tax purposes should generally be exclusive of the VAT where such VAT is allowed to be deducted in the taxpayer's VAT return.

g. Payment of interest for delayed refunds

In order to achieve the VAT's overall intent, policy makers should ensure that legislative provision is made to refund legitimate refunds within a specific time period. Failure by the tax administration to refund the VAT due, should result in the payment of interest to the taxpayer. Such interest payment which would negatively impact the revenue collected in that it is a drawback on the revenue collected, is compensation to those taxpayers who were not refunded timeously. It is furthermore intended to be a deterrent to tax administrations to delay the prompt payment of refunds. However, the payment of interest for the late refunding of VAT refunds may by no means be adequate compensation to the taxpayer particularly where the taxpayer is reliant on the refund for business continuity.

6. Impact on taxpayers where inefficient refund mechanisms/processes exist

Acknowledging that VAT-registered businesses play a key role in the collection of VAT emphasises the importance of an efficient and robust for managing and paying VAT refunds.

There may be systems in place to pressure tax administrators to pay the VAT refunds, but these processes are time consuming and costly.

a. Negative cashflow / Interest expense/ exchange rate fluctuations

A consequence of the accrual based system of accounting for VAT, VAT registered businesses are required to pay over VAT charged on sales despite not having actually collected the VAT from their customers at the time that such VAT is paid to the tax administration. This requirement places a strain on the cashflow of the VAT registered business as the business is required to fund the payment of VAT due.

This is further compounded when there are delays in the payment of VAT refunds. Businesses may in some instances be forced to fund the payment of VAT and the delayed VAT refunds by raising funds from external sources. This creates an additional interest expense for businesses.

Businesses that are unable to raise external funding may face dire consequences, which can lead to business closure or default on other financial commitments.

b. Costs incurred e.g. Professional services to engage with tax administration due to *inter alia* the increased likelihood of audits, follow up regarding outstanding refunds.

The processes of VAT refund enforcement activity (e.g. audits) and obtaining outstanding VAT refund pay-outs have become complicated and also time consuming for businesses. Whilst there is an acceptance that tax administrators have to implement steps to prevent tax evasion and the payment of undue refunds, caution should be exercised in the demands placed on taxpayers to communicate and provide information to the tax authority, which may create a burden on taxpayers' available resources.

Many businesses may therefore prefer to hire external professional service providers.

Both these options (additional resources or external professional service providers) are expensive and impose an additional cost on businesses.

c. Impact on business – contradicts principle of VAT not being a cost to VAT registered business
   i. Increases cost for business that –
      - will ultimately be passed on to the customer; or
      - decrease business profits; and
   ii. results in tax cascading where customers are VAT registered businesses.

7. Tax administration considerations

a. Registration risk

The registering and subsequent issuing of a VAT number requires a taxpayer to levy VAT on its taxable transactions and account for and pay such VAT to the tax administration. In addition, the taxpayer is entitled to deduct the VAT incurred on qualifying expenses. As discussed above, the registration process is the most important line of defence against admitting fraudulent taxpayers into the VAT net.

b. Revenue risk mitigation

Efficiently identifying risk in the refund process is key in reducing unnecessary engagements with taxpayers. It is recommended that general as well as sectoral specific risks are continuously identified and implemented by the tax administration to reduce the likelihood of processing invalid refund claims. Engaging with other tax administrations to obtain information on current and past refund scams would assist tax administrations in pre-empting fraudulent claims being processed.

c. Resource allocation

Tax administrations should consider the adequate allocation of resources throughout the VAT value chain in order to improve service delivery and overall taxpayer experience. The use of data and automation in the value chain would assist tax administrations to effectively allocate appropriate resources. Upskilling appropriate staff would also enable tax administrations to reallocate staff to different business units when required.

8. Fraudulent refund schemes

9. Conclusion

The forecasting, budgeting, assessment of risk and ultimate processing of VAT refunds is a complex process that spans across multiple stages in a tax administration's operations. The efficient balancing of adequately budgeting for the payment of refunds, processing valid refund claims within legislatively provided time periods and the reality of ever-increasing fraudulent VAT refund schemes being perpetuated against tax administrations, requires tax administrations to constantly improve the relevant processes. The importance of legitimate VAT refunds being paid timeously to taxpayers is crucial in ensuring that the VAT achieves its ultimate purpose of taxing final consumption.

Annexure A

Pakistan: Automation of Sales Tax Refunds – A Case Study

I. Background

Pakistan's tax system has undergone significant reforms over the past five years, inter alia, leading to the modernization of both direct and indirect tax refunds. Pakistan simultaneously remained focused on both bolstering exports to stimulate economic growth and increasing the tax revenues. Perking up investment, exports, and revenues as a percentage of gross domestic product (GDP), is essential for guaranteeing the desired level of growth in an economy over medium and short terms. Sustainable economic growth depends on exports by earning foreign income to finance imports, service foreign debt, stabilize foreign exchange and to overcome the persistent problem of balance of payment deficit. For a developing country, an export-led growth strategy is the one where a country seeks economic development by opening up to international trade and foreign direct investment through liberalization and structural reforms. The opposite of an export-led growth strategy is import substitution, where countries strive to become self-sufficient by developing their own manufacturing industries through incentive led investments.

2. Most countries for multiple reasons tend to tax raw materials at import stage and then refund the tax to the extent attributable to exports undertaken and adjust against final tax liability the sum attributable to local supplies in the domestic market. The problem of exporters to first pay taxes and then later struggling to obtain refunds is an arduous policy choice and a disincentive for several reasons. Pakistan like most developing countries, due to omnipresent fiscal constraints, was traditionally not paying refunds due, or would not collect tax at the time of purchase or import of raw material thereby leaving holes in the taxation of the entire value chain – the so-called zero-rating regime. Illustratively, at the onset of fiscal year (FY) 2021-2020 the government owed refunds worth over Rs 350 billion to exporters, which was almost 1 percent of the total tax revenue collected for the year.

II. Zero Rating Regime

3. The zero-rated regime on local supplies, for the whole textile supply chain was first introduced by the Finance Act 2005 to stimulate export-oriented sectors in Pakistan and to minimize tax fraud through fake and flying invoices, which was purportedly resulting in more refunds than tax collection. Zero-rating was then withdrawn in 2013 without providing the expeditious refund system that was committed, thereby creating liquidity crunch for exporters, and compelling them to borrow from the banking sector to run their production process. Afterward, zero-rating was restored in 2016 but finally rescinded for the export-based industries in the June 2019 budget announcement.[11]

4. The net effect of the SRO 694 was that from July 01, 2019, the items listed in the said SRO had been made liable to sales tax @17% at import and local supply stage. However, in case of integrated retail outlets, sales tax on finished textile and leather items were subject to 14% sales tax, according to the circular. The tax administration argued that the decision to eliminate the zero-rating regime was taken due to gross misuse of the scheme. It was also widely believed that the zero-rating regime had been used for the issuance of bogus refunds

[11] FBR's SRO 694(I)/2019 dated June 29, 2019 rescinding SRO 1125(I)/2011 dated December 12, 2011 w.e.f. July 2019 explanation to which was provided vide Circular No. 1 of 2019, darted July 26, 2019.

through the use of fake and flying invoices resulting in huge monetary losses to the national exchequer.

5. The FBR estimated that the domestic sales of the sector were about 40% of industrial output and somehow the sector was evading massive amount of sales tax on domestic sales. After the withdrawal of zero-rating, net sales tax collection from textile sectors sharply increased to Rs. 61.2 billion during the fiscal year 2020 as compared to Rs. 8.7 billion in the preceding fiscal year reflecting a growth of little over 6 times. This unprecedented growth in sales tax collection from the sector could be attributed to elimination of zero-rating scheme through Finance Act, 2019 although the collection of sales tax from textile sector would have been much higher but for the Covid-19-induced economic slowdown. Later, in the post Covid 19 period, Export Industry benefitted from the rising global demand with textile exports registering an all-time high growth of 36 percent in the year 2021.

III. Fully Automated Sales Tax Electronic Refund System

6. In order to resolve the issue of exporters in obtaining refunds under new schemes from July 01, 2019, FBR introduced Fully Automated Sales Tax e-Refund (FASTER) system with a commitment and a mechanism that the refunds would be issued in 72 hours. This automated system ensured disbursement of refunds in an expeditious and transparent manner to ensure that exporters did not face any liquidity crisis.

7. To achieve the overall intent of post zero-rated regime, the challenge before the tax administration was three-fold, that is, (a) to issue refunds timeously; (b) to issue refunds correctly sans any element of fraud; and (c) to take out all possibilities of rent seeking. Particularly, whilst a sales tax premised on the principle that refunds are paid timeously, the reality of fraudulent refund claims as well as the submission of non-qualifying input tax credits using fake and flying invoices that result in a refund claim, was a constant reality and burden faced by the tax machinery like in many other countries – particularly developing ones.

8. A key element of a good refund system is a continuous process of identification of risks and mitigation techniques to sort out fraudulent refund claimants as well as suppliers in a whole supply chain. A rule-based system allows for the bulk processing and risk assessment of invoices and the return data thus enabling data to be reviewed against a set of risk indicators and the calculation results to be used for deferring in valid claims. Therefore, risky profiles are not processed under FASTER, instead are forwarded for manual processing.

IV. FASTER Process Flow

9. Following are the stages involved in the automatic GST refund process:-

- Issuance of sale invoices
    - Electronic invoicing
    - Point of Sales (POS) Integrated invoices
    - Batch invoice Submission
    - Filing of Sales Tax Return /Monthly Declaration
- Submission of Refund Application/ Consumption Statement
- Processing of Refund
    - Electronic Refund Processing (Automatic)
    - Manual Processing

- Payment of Refund
    - PO (Payment Order) /Cheques/ Tradeable Bond
    - Electronic payment

IV. FASTER System – Salient Features

10. Following are the technical features for refund processing in FASTER system: -

(i) The FASTER System does not take refund as an isolated process but only as a cog in the wheel of an integrated system in the whole supply chain for purchases of goods and services from suppliers at multiple tiers. Sales tax paid on purchases termed as input tax credit; i.e., tax paid by a taxable business in relation to goods or services supplied to him or imported for the purpose of business activity. This Input Tax Credit - ITC is adjustable against the output tax accrued against taxable supplies and excess of credit is refundable.

(ii) The FASTER System's success relies on validity of input tax credit in credit ledger of sales tax return in a supply chain based on pre-verified sales tax invoice verification system commensurate with the refund demanded by the claimant, thus linking a whole supply chain of vat regime of suppliers; wholesalers, distributors, manufacturer, importers and the end-consumers. The system guarantees that buyers only claim valid input tax credit against which the return is submitted and due taxes are paid. Thus, there is no need of time taking, cumbersome process of cross matching of the particulars of invoices between the buyers and the suppliers. This mechanism eliminates successfully the fake invoicing in the VAT regime meaning thereby that there is no chance of claim of a credit against which tax is not paid. This mechanism not only reduced time and effort of data entry but also eliminated errors and false declarations.

(iii) The FASTER System framework of invoice verification provides control of duplicate claim of credit on the same document that was possible in manual cross matching technique.

(iv) Another big issue was of flying invoices, where tax is paid for the purpose other than the refund claim against the exports but credit invoice is purchased from the market of non-relevant goods or same goods but for end consumer. FASTER System in built relevancy framework manages negative list of HS Codes which are declared non-admissible to block refund claim and forward the same for audit.

(v) The System uses classification of inputs into following categories and the risk scoring both quantitatively and qualitatively for marking dynamic thresholds to manage excess refund claims.

(vi) Some of the critical ratios and risk parameters built into the system are as follows: -

- Total ratio of power/energy consumed
- Total ratio of basic raw material
- Total ratio of packing material
- Total ratio of services consumed
- Total ratio of plant and machinery credit used for the claim
- Total ratio of finished product consumed.

(vii) To restrict erroneous filing of refund claims and to ensure that only valid refund claims are filed, entry-gate validation check points have been applied in the FASTER System. This ensures that all the filed refunds are processed. No refund claim is stuck up at the pre-processing stage.
(viii) If a refund claimant files his refund claim with errors, the system would guide him/her upfront during filing in easy non-technical language.
(ix) Parameters have been updated to categories ex-zero-rated sectors so that refunds claims are properly channeled through the FASTER module.
(x) Suspected refund claimants and suppliers are filtered on risk-based criteria to disallow refund claims on an automatic basis.
(xi) Export is verified for consumption with Pakistan Customs data and realization of export remittances is verified from the banks through an integrated system based on risk.
(xii) Auto-implementation of negative list of HS Codes for admissibility of credit.
(xiii) Auto-updating and management of risk register based on thresholds, sectoral profile and benchmarks.
(xiv) Random audit selection of processed refunds for review of risk register. Dashboard to view the stage-wise update regarding refund claims without contacting any officials.
(xv) A mobile app, which enables GST refund claimants to view the status of their refunds claim at each stage of processing, has been made part of the FASTER Plus System – a newer version of the FASTER System.
(xvi) Updates on refund status could also be ascertained by sending a SMS at 9966 through registered mobile number of the refund claimant.
(xvii) Risk evaluation and assessment of Taxpayers profile to incorporate in refund processing.
(xviii) Marking and updating the negative list of HS Codes for input tax credit.
(xix) Management of FIFI que in every stage of processing.
(xx) Issuance of online payment using real-time gross settlement system of central bank through a centralized payment system.

VI. Conclusion

11. The FASTER System processes more than 90% of the claims within 24 hours of filing and those identified as risky ones are deferred for another review and manual reprocessing. The System is fully automatic, centralized and encrypted for safety. Risks involved in refund processing are mitigated through a post refund audit processing. The FASTER System has conveniently taken pressure off the political governments for prompt release of funds, and from exporters as they now do not have to pay avoidable production cost and render then price-competitive in the international market.

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Mexico

There is a special program focused on exporting companies in Mexico, called the IMMEX program, whose purpose is to support this industry through VAT payment facilities.

In order to have access to this program, it is necessary that the companies comply with a registration before the authorities to be certified as members of the IMMEX program. It is worth noting that it has been a very beneficial program for Mexico and for the certified companies, since it has strengthened the export of products manufactured in Mexico to foreign countries and, likewise, it has been an effective program for the detection and prevention of fraud related to VAT refund requests, since there is strict control over who are the participants of this program.

In order to have access to this program, taxpayers must comply with several requirements, such as the following:

1. Export Value

An IMMEX company has to perform annual export sales that amount at least $500,000 USD, or their billed exports must represent at least 10% of its total turnover.

2. Legal and Tax compliance

To be a legal entity and be taxed under the general regime of the Mexican Income Tax Law, obtain a Tax ID and designate a legal representative.

3. Authorized Facilities

Maintain the material object of *maquila* in the indicated facilities, within Mexican territory.

4. Inventory requirements

To use the goods for the purpose for which they were authorized and have inventory control.

5. Annual Report

An IMMEX company has to submit electronically an annual report no later than the last business day of May to the Tax Administration Service, to notify its total sales and exports of the previous tax year.

6. Statistics Reports

An IMMEX company has to submit information to the National Institute of Static and Geography (INEGI, Spanish acronym) for statistical purposes.

7. Filing of documents

To request the benefits of the IMMEX program, Companies have to fill out the application with the Mexican Government, attaching among others, documentation as certified copy of the company's Articles of Incorporation and, where appropriate, its amendments; *maquila* contract, purchase contract, purchase orders or confirmed orders, which prove the existence of the export project and a free format letter detailing the production process or services referred to in the program application.

Refund statistics [12]

Set out below is a recommended initial list of analyses that can be performed by a tax administration as a means of monitoring VAT refund claims and payment performance. Anomalies in refund claims and overall VAT performance can therefore be identified and action taken, where necessary.

- VAT as % of GDP
- Refunds as a % of VAT collections including import VAT
- Best practice – monitoring of refunds YoY, sectors, trends
- Analytical tools to estimate refunds for an identified period including the functionality to monitor and adjust where necessary
- Refund claims vs refunds paid (i.e. liability management)
- Highest contributing sectors in terms of value and number of claims
- Comparison to prior years of VAT refund claims and values
- Import VAT paid by importers and the impact if any on importers' VAT liability
- The impact of standard rated purchases and VAT paid on import where such results in the submission of credit returns
- Trends in VAT registration applications – nature of persons and regular monitoring of new registrants' VAT liability / refund claims
- The yield arising from VAT refund audits including the number of cases resulting in litigation and the final outcome thereof.

[12] RA-FIT Data 2021 - Standard Tables - ISORA (rafit.org)