

Attachment C:

VAT in the Extractives Industry (Outline of Guidance Note)¹

Purpose: Although extensive work has been done on direct tax instruments in the tax structure surrounding investment in oil, gas, and mining sectors, little systematic attention has been paid to the role of indirect taxation, both as barrier/facilitator to direct investments as well as a factor in spillover effects into the local economy. Recent experience in African countries has revealed that both policy and administration of VAT in extractive investments have affected investor decisions and are a lynch pin for local content sourcing.

In particular, VAT policy (use of exemptions vs. zero rating, credit for input VAT on taxable supplies of goods and capital assets) and relatedly administration (refund mechanisms, use of risk tools, investment trader mechanisms, VAT deferment schemes), are key elements in extractive taxation frameworks. Specifically, the application of exemptions (incentives) for (foreign) direct investments have led to breaks in the domestic VAT chain, which has resulted in market distortions for related goods and services especially for local suppliers.

Additionally, both the policy distortions and the complications in VAT refund systems (identification of legitimate claims, forecasting timing and levels, provisioning, refund mechanisms) has resulted in cash flow and transparency issues which affect investment decisions.

This guidance note will explore both the VAT policy and administrative issues affecting extractives investment. The paper will be organized as follows: definition of the issues, country experience, identification of good practices, and guidance for practitioners.

Proposed outline:

- I. Defining the issues: application of VAT in extractive industry investments***
 - a. VAT policy during exploration discovery, development and extraction (goals, challenges)
 - b. VAT administration during exploration discovery, development and extraction (goals, challenges)

This section will set out both the policy and admin parameters, and how the use of VAT both as an incentive (exemptions) and a means to ringfence for tax extractives investments.

¹ This draft was prepared by Richard Stern with input from other Subcommittee Members.

II. Discussion of VAT in practice

- a. Policy/administration as a part of the investment value chain for direct investment
- b. Policy administration as a component of a local content sourcing policy
- c. Differences in issues arising from VAT applied to mining vs. oil and gas
- d. How these applications play out (cost-benefit)
- e. Country experience (putting theory to the test)

This section will focus on VAT as applied to direct extractive investments, subsidiaries, and local content sourcing

III. Towards defining good practice

- a. What does a good VAT regime look like in the extractives sector for direct investments
- b. What does a good VAT regime look like to foster local content sourcing?
- c. Are there inherent contradictions between a) and b) and if so, what is a good middle ground?
- d. Country examples?
- e. How do we measure a “good” VAT system (participation, revenue, investor satisfaction)?

This section will focus on determining components for a comprehensive VAT system that taxes value addition and facilitates both direct investment and local content sourcing.

IV. Recommendations and conclusions.