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VAT REFUNDS IN CROSS-BORDER TRANSACTIONS: THE INTERNATIONAL EXPERIENCE

Krishna Shorewala*

ABSTRACT

While the VAT has risen to dominance within a short span of time, issues relating to VAT refunds like frauds and delays in refunds have haunted the VAT systems around the world. This paper seeks to compare the experiences of three jurisdictions with the VAT: the European Union, Brazil and China and seeks to plot the points of convergence and divergence in the international experience. Through the paper, the author intends to demonstrate four points: (1) the issues that arise in the area are substantially similar across jurisdictions; (2) these issues are largely administrative/procedural in nature requiring policy rather than simply legal intervention; (3) since the VAT systems differ significantly, the manifestation of these problems differ across jurisdictions; and (4) as a consequence of the unique features of these VAT systems, the solutions to the issues not only may but must differ from one jurisdiction to another.

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I. INTRODUCTION

The VAT has risen to dominance in a span of 50 years from its first application. Today, it is one of the most popular forms of indirect taxes. In cross-border transactions, the treatment of goods and services is dependent on the principles on which the VAT is imposed and the structure of the VAT system. Ordinarily, the destination principle has provided the basis for most states internationally for the treatment of cross-border transactions. However, this has led to several issues like delays in refunding on the part of the governments and frauds on the part of the taxpayers which many countries today are grappling with.

For an aspect that has been regarded as the weakest link in the VAT chain, there is surprisingly little scholarly writing dealing with the issue of refunds in the VAT. This aspect of the VAT has given rise to a number of issues in addition to the abovementioned ones particularly in the area of cross-border transactions internationally. However, little scholarly writing is available dealing with these issues in a systematic manner.

This paper seeks to contribute to the existing VAT literature by plotting the points of convergence and divergence in the international experience in relation to the VAT refunds in cross border transactions. It seeks to study certain VAT systems from this perspective and draw conclusions from there. The author has chosen three jurisdictions – Europe, Brazil and China to study for this purpose. They have been chosen because each of them has its own unique experiences and background to offer. Also, considering the literature available and the levels of development, the European Union has been given a stronger focus than the others.

Through the paper, the author intends to demonstrate four points: (1) the issues that arise in the area are substantially similar across jurisdictions; (2) these issues are largely administrative/procedural in nature requiring policy rather than simply legal intervention; (3) since the VAT systems differ significantly, the manifestation of these problems differ across jurisdictions; and (4) as a consequence of the unique features of these VAT systems, the solutions to the issues not only may but must differ from one jurisdiction to another.

In order to achieve this, the paper is structured in the following manner: Section I provides an overview of the relevant concepts including the VAT, Origin and Destination Principles and the treatment of exports in VAT systems. Section II charts the experience of the European Union (EU) with VAT refunds in cross-border

transactions. In Section III, the Brazilian experience is similarly considered and in Section IV, the VAT in China is examined followed by Section V which plots the points of convergence and divergence in the international experience.

II. A CONCEPTUAL OVERVIEW

A. Value-Added-Tax

Regarded as the “*darling of tax pundits*”¹ and the “*Mata Hari of the tax world*,”² the concept of value added tax (VAT) was first developed in 1919 by the German businessman Dr. Wilhelm von Siemens and accepted by France first in its initial form in 1948, Brazil in 1967.³ The reach of the VAT has grown remarkably in the period thereafter. Accepted by 143 countries at various stages of economic development as of 2007, it is said to account for 20% of tax revenues globally and affects 4 billion people or more.⁴

The growth of the VAT has been linked to the growing dependence of developed countries on revenues from indirect tax. It represents a shift from taxing income to taxing consumption.⁵ The VAT is ordinarily a consumption tax imposed on the value added on goods at different stages of production. It is the consumer who finally pays the tax. In effect, the term “value added” is arrived at by deducting the cost of inputs (meaning capital goods and raw materials but not labour costs) from the total price at which the output is sold. Therefore, it is a multi-stage commodity tax collected on sales at all stages of production and distribution.⁶

1 Sukumar Mukhopadhyay, *VAT: A Closer Look*, 36(7) *ECONOMIC AND POLITICAL WEEKLY* 522-524.

2 ALAN TAIT, *VALUE ADDED TAX: INTERNATIONAL PRACTICE AND PROBLEMS* (International Monetary Fund 1988) cf Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach* (Cambridge University Press 2007) at 1.

3 SUKUMAR MUKHOPADHYAY, *ECONOMICS OF VALUE ADDED TAX*, 24 (CENTAX Publications, 2005). [Hereinafter, “MUKHOPADHYAY”]

4 John Norregaard & Tehmina S. Khan, *Tax Policy: Recent Trends and Coming Challenges* (International Monetary Fund, Working Paper No.WP/07/274).

5 The conventional distinction between consumption taxes and income taxes is that the former are imposed on the sale and purchase of goods and services while the latter are levied on the compensation to labour as well as the return on savings and investment. Another important point of distinction is that the consumption and labour incomes are equivalent but the consumption and comprehensive income (labour income + capital income) are not. Therefore, shifting towards taxing consumption is, in effect, a shift toward taxing only labour income rather than comprehensive income.

6 MUKHOPADHYAY.

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Since the price of the final consumer good is equal to the sum of value added at each stage, a broad-based VAT and a comprehensive retail sales tax have equivalent tax bases - final consumption by households. However, the collection machinery in both differs significantly. While a retail sales tax taxes final consumption value at the end of production and distribution, the VAT taxes the value added at each stage of the production and distribution until it reaches the final consumer. In retail sales tax, the tax is collected at a single stage and, in case of the VAT, the collection is done at multiple stages.⁷

There are many reasons (real and perceived) for the appeal of the VAT. First, the VAT is viewed by governments as an easy way of raising extra government revenue as a broad-based VAT that striking taxpayers indirectly allows for considerable increases in revenue at relatively low rates.⁸ Further, it was found in more developed economies that there was too much reliance on direct taxation which led to the shift in order to obtain an optimal tax mix.⁹ Third and most importantly, the specific choice of the VAT over other forms of indirect taxation was because of certain values attributed to the VAT which led to its inclusion in indirect tax reform measures. Ordinarily, the three arguments levelled in favour of the VAT are: (1) neutrality; (2) avoidance of cascading effect and (3) achieving zero rating of exports. However, it has been conclusively shown that these are either untrue or better achieved through other means.¹⁰ However, as Alan Tait points out, in case of the VAT, it is possible to know the tax content of a product at any stage of production and the VAT is relatively unavoidable as compared to retail sales tax. The check on evasion is an integral part of the VAT. Further, it prevents vertical mergers solely for the purpose of reducing tax liabilities unlike turnover taxes.¹¹ However, at the same time it is a costlier and more complicated system to administer.¹²

In case of developing economies, Shoup argues that, unlike a retail sales tax where the burden of paying taxes is concentrated on retailers, the VAT has the

7 Wayne R. Thirsk, *The Value-Added Tax in Canada: Saviour or Siren Song*, 13(3) CANADIAN PUBLIC POLICY / ANALYSE DE POLITIQUES 259. [Hereinafter, "Thirsk, *VAT in Canada*"]

8 Thirsk, *VAT in Canada*, at 260.

9 Thirsk, *VAT in Canada*, at 261-263; Martin Nort & Nils G. Hornhammar, *The Value-Added Tax in Sweden*, 70(3) COLUMBIA LAW REVIEW 379.

10 *Supra* note 2; Sukumar Mukhopadhyay, *Value Added Tax: How Implementation is Going Wrong*, 37(36) ECONOMIC AND POLITICAL WEEKLY 3700 (2002).

11 Carl Shoup, *The Value Added Tax and Developing Countries*, 3(2) THE WORLD BANK RESEARCH OBSERVER 139. [Hereinafter, "Shoup, *The VAT and Developing Countries*"]

12 ALAN A. TAIT, *VALUE ADDED TAX* 122-126,136 (McGraw Hill Book Company, 1972) . [Hereinafter, "TAIT"]

major advantage of spreading the responsibility of taxpayers much more widely and in smaller amounts. Even if the one link in the chain (say, the manufacturer or the retailer) fails to file returns, under the VAT, significantly less revenue is lost as only the revenue for the value added at that stage is lost. Secondly, the VAT can be structured in a manner so as to leave capital goods untouched and tax only consumption goods. Thirdly, zero rating of exports is easier under the VAT than under retail sales tax.¹³ However, this doesn't mean that the VAT is suitable for all developing countries. Certain criteria have been prescribed which should be met in order for the VAT to be suitably introduced in that state.¹⁴ At the same time, one of the strongest criticisms of the VAT is that it is harsher on the poor than the rich and is regressive,¹⁵ though the regressivity can be checked through increased social spending particularly on the poor and additional taxes on the rich for funding additional redistribution measures.¹⁶

B. *Origin and Destination Principle*

There are two principles on the basis of which the VAT may be imposed. The first is the 'origin principle' which a VAT system is said to use when it taxes value that is added domestically to all goods including exports but does not tax any value added abroad and is embodied in imports which are sold domestically. All value that originates within the state is taxed and only that value is taxed. Therefore, imports are exempt from the VAT whereas exports are taxable.¹⁷ This

13 Shoup, *The VAT and Developing Countries*, at 149-151.

14 It has been argued that in a developing country which:
 has a dominance of very small retail units;
 has no prior experience with sales tax implementation;
 has failed to achieve administrative competence in collecting and enforcing a sales tax;
 has inadequate account records maintained by its firms and very low levels of tax such that the discriminatory effects of turnover taxes may be insufficient to warrant a more complex and comprehensive tax such as VAT;
 the introduction of VAT would be unsuitable as the benefits of such a shift will be too little considering the costs that are involved. George E. Lent, Milka Casanegra & Michele Guerard, *The Value-Added Tax in Developing Countries*, 20(2) STAFF PAPERS - INTERNATIONAL MONETARY FUND 318.

15 Sijbren Cnossen, *Key Questions in Considering a Value-Added Tax for Central and Eastern European Countries*, 39(2) STAFF PAPERS - INTERNATIONAL MONETARY FUND 211.

16 This was seen in the VAT model introduced in Sweden in 1969. Martin Norr & Nils G. Hornhammar, *The Value-Added Tax in Sweden*, 70(3) COLUMBIA LAW REVIEW 379.

17 Carl S. Shoup, *Choosing among Types of VATs*, cf. VALUE ADDED TAXATION IN DEVELOPING COUNTRIES 1-16 (Malcolm Gillis, Carl S. Shoup & Gerardo P. Siscat eds., World Bank, 1990). [Hereinafter, "Shoup, *Choosing among Types of VATs*"]

principle is rarely applied in practice with the only remnants of its application being found in CIS countries¹⁸ and the lack of complete zero-rating of exports in countries like China.¹⁹

In contrast to this, the destination principle is said to be applied in a VAT system when the tax is imposed on the value added, domestically and abroad, to all goods which have their destination the consumers of that country. Exports are exempt and imports are taxed.²⁰ Under a pure destination principle, it is essential that the country imposing the VAT maintain "fiscal frontiers" (border tax adjustments).²¹ Most governments around the world opt for the destination principle. It is argued that the preference stems from the preference for consumption VAT over income VAT. A consumption VAT has goods & services which are sold or transferred for personal consumption within an economy as its base while income VAT has the jurisdiction's net national income as its base.²²

C. Input Credits and the Treatment of Exports in Destination Based VAT

Input credits usually feature in systems employing the credit-subtraction VAT as opposed to a sales-subtraction method VAT where tax is paid at the applicable rate on the difference between taxable sales and allowable purchases both inclusive of tax.²³ In such a system, the taxpayer determined his tax liability by deducting his input credit from his output tax. This method is applied in two ways: credit-invoice VAT and credit-subtraction VAT without invoice. In the former, reliance is placed on invoices to verify tax reported by the sellers on taxable sales and the input credit which is claimed on allowable taxable purchases by the purchasers. This method is the preferred method and applied in the European Union (EU). The Japanese Consumption Tax is the only major example of the latter.²⁴

Input credits are credits that the taxpayer may take against the output VAT that was paid or deemed to be paid on the purchases that qualify for credit. In a

18 The Commonwealth of Independent States are the states formed out of the former USSR in December 1991. It consists of Azerbaijan, Armenia, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Uzbekistan and Ukraine. Their interaction is based on the principle of sovereign equality. Available at <http://www.cisstat.com/eng/cis.htm>.

19 Alan Schenk & Oliver Oldman, *Value Added Tax: A Comparative Approach* 182 (Cambridge University Press, 2007). [Hereinafter, "Schenk & Oldman"]

20 Shoup, *Choosing among Types of VATs*, at 7.

21 Schenk & Goldman, at 183.

22 Shoup, *Choosing among Types of VATs*, at 7; SCHENK & GOLDMAN, at 20-21.

23 Schenk & Goldman, at 22.

24 Schenk & Goldman, at 20-21.

consumption VAT, credit is ordinarily allowed for the VAT paid on capital goods, raw materials, input services, inventory and intermediate goods and services used.²⁵

One of the justifications for the VAT is that exports grow in VAT systems. However, this has been systematically disproven and it has been shown that the argument is not true in every state. As Tait points out, the effect on exports is dependent on the positive response of the producers, exports consumers and the negative response of domestic consumers to market prices of imports relative to market prices of domestically produced goods. Thus, the effect varies with individual countries.²⁶

In a VAT system based on the destination principle, exports are free of taxes as they are not directly consumed in the territory in which they are produced. This is achieved through the practice of "zero-rating" where not only is no tax imposed at the time of the exporting of the goods but also, it allows the seller to deduct the tax which has paid on inputs and recover it. Unlike exemptions, through the process of zero rating, no VAT is charged on the goods and the VAT paid earlier along with that paid on inputs is refunded. Such rebating makes exports highly profitable. Often, exporters in a country sell exports even below the cost of manufacture as the refunds allowed are more than enough to cover the losses so incurred. Therefore, zero-rating is seen as making exports more competitive. At the same time, on imports, the tax imposed is the same as on domestically produced goods. Therefore, the VAT ensures equal treatment of the goods.²⁷ Like the foreign tax credit in the U.S. for offsetting the income taxes imposed on the same income by foreign states,²⁸ such zero-rating helps ensure the removal of artificial barriers in cross-border transactions which otherwise hinder the comparative advantage economic theory that supports free trade.

D. Refunds in VAT

Refunds are a key feature of the invoice-credit VAT system described above as businesses will pay more amounts than they collect as VAT from taxable sales

25 Schenk & Goldman, at 22.

26 ALAN A. TAIT, *VAT Policy Issues: Structures, Regressivity, Inflation, and Exports*, in *VALUE-ADDED TAX: ADMINISTRATIVE AND POLICY ISSUES* 9-10 (Alan A. Tait ed., International Monetary Fund, 1991).

27 MUKHOPADHYAY, at 174, 176.

28 Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *What's Source Got to Do with It? Source Rules and U.S. International Taxation*, 56 *TAX LAW REVIEW* 81.

and hence, should be able to reclaim the difference.²⁹ The issue of VAT Refunds is particularly prominent in relation to exports. This is because exports are generally zero rated and free of tax. Hence, it is common for exporters to report excess input VAT in periodic VAT returns. It is presumed in VAT systems that this excess VAT will be recovered in order to prevent these inputs from being included in the pricing structure for taxable sales. Therefore, in order to achieve this, VAT systems grant exporters the right to recover excess input VATs within a reasonable period after the input tax is recovered.³⁰

According to a recent survey that was conducted by Harrison and Krellove, it was that that while refunds vary from region to region, they are seen to be higher in developed and transitional economies. Most countries have statutory periods prescribed within which the VAT amount is to be refunded. These periods range from 24 hours in Peru to 90 days in France. Ordinarily, it was found that, in many countries, a period of 30 days is provided for. Some countries even allow for interest to be charged for late payment of refunds. A de minimus rule is put in place by countries like Singapore and United Kingdom where interest is paid only when it is calculated to be higher than a statutorily prescribed minimum. Some countries like Italy, France and Peru disallow refunds which are below a minimum threshold. Many countries provide for carrying forward their excess VAT credits for specific prescribed periods. These periods range from 30 days to more than a year. Ordinarily, it was found to be 3-6 months. Only the excess credit remaining to be recovered by the taxpayer at the end of such period can be recovered. VAT refunds are also allowed to be off set against other tax liabilities like income tax by a large majority of the countries.³¹

The problems plaguing refunds have been described as the "Achilles heel of the VAT."³² As Mukhopadhyay points out, *"the input credit system creates by its very nature, extreme proneness to evasion poses the biggest threat that VAT brings in its trail."*³³ The faults lie on both sides: the government as well as individual units involved in business activities. The problems range from delays and corruption on the part of

29 Mukhopadhyay, at 289.

30 Schenk & Goldman, at 167.

31 Graham Harrison & Russell Krellove, *VAT Refunds: A Review of Country Experience* (International Monetary Fund, Working Paper No. WP/05/218). [Hereinafter, "Harrison & Krellove, IMF Working Paper"]

32 Harrison & Krellove, IMF Working Paper.

33 Sukumar Mukhopadhyay, Value Added Tax: How Implementation is Going Wrong, 37(36) Economic and Political Weekly 3700-3703 (2002).

the governments collecting the revenue to fraud and under-invoicing by business owners. This has led to considerable tension and made the VAT fairly controversial. It is essential to tap into experiences from different parts of the world to evaluate these issues and the manner in which they may be addressed.

III. THE EU EXPERIENCE

A. Historical Overview

The story of the VAT in Europe is intricately linked to the quest for a common market. The VAT swept through Western Europe only after 1968 subsequent to the establishment of the European Economic Community [Hereinafter, "EEC"] pursuant to the Treaty of Rome in 1957 and the abolition of all customs duties and quotas in the trade between EEC member states. The Report of the Fiscal and Finance Committee chaired by Prof. Fritz Neumark visualised the acceptance of all stage the VAT systems by all EEC states which would be identical or almost identical in both form and content in terms of structure, rates, exemptions etc., in a gradual manner.³⁴ In pursuance of the recommendations of the Neumark Report, two Directives were issued by the EEC for all members to switch from a gross turnover tax to VAT. As a result, countries like Germany, France,³⁵ Netherlands and after some delay, Italy and Belgium switched to the VAT.³⁶

At the same time, without any formal directives, the European Free Trade Association members also decided to shift to a tax on value added rather than sales tax. Therefore, countries like Denmark in 1967, Sweden in 1969 and Norway in 1970 also introduced the VAT within their jurisdictions. For countries like Sweden, it marked a shift in its reliance as an affluent society from direct taxation to indirect taxation for funding its increased social expenditures. The shift was due to the political difficulties involved in increasing the (already high) rates of income tax to generate the much needed public funds for social expenditures and the perceived advantages of the VAT over sales tax.³⁷

34 Eric Schiff, *Value Added Taxation in Europe* 5 (American Enterprise Institute for Public Policy Research, 1973).

35 France, as already mentioned earlier, had introduced a rudimentary form of VAT way back in 1948. However, it covered only mining, manufacturing and some special cases of wholesale trade before the reforms of 1968 were undertaken. Till 1967, no country in Europe had a VAT system which extended over all stages of production and distribution of commodities and over the majority of services. See footnote 34, at 1.

36 Tait, at 144.

37 *Supra* note 17, at 379-381.

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The next significant step in the story of the VAT in Europe was the issuance of the Sixth Council Directive³⁸ which provided for further harmonisation of national VAT laws across the EEC member states. The Directive not only provided for a more precise definition of taxable persons, taxable transactions, taxable amounts etc. but also drew up a uniform list of exemptions, harmonised the rules of deduction and adopted common schemes of taxation of agriculture, small undertakings etc. It provided for an equal treatment of domestic and cross-border transactions and required that taxes imposed be proportional to the price on which the tax is imposed irrespective of the number of stages between the production of the good and its consumption. It sought to encourage inter-penetration of the economies of member states. This was an important step in achieving a single common European market.³⁹

In the aftermath of the Cold War, a number of Central and Eastern European countries (many of whom subsequently also became members of the European Union), adopted the multi stage, consumption VAT based on the destination principle prevailing in Europe, as a part of the shift from a planned economy to a market-oriented economy.⁴⁰ However, the most important step was taken in pursuance of the recommendations in the Cockfield White Paper,⁴¹ through the introduction of the new “*transitional system*” made operative from January 1 1993. Here, border controls and tax adjustments were abolished altogether and a common market was finally introduced. The VAT was administered on a deferred payment or postponed accounting basis. The VAT is imposed on an invoice basis and the firms are to furnish periodical details of their sales. The system works on self-assessment by the importers who pay only when the goods are sold. A more “definitive” system was contemplated to be introduced by 1997 but is yet to be seen due to existing political and technical difficulties regarding the issues at stake.⁴² However, the Sixth Council Directive with its various amendments was recast into the Council Directive in 2006 which now is the primary law governing the VAT in the EU.⁴³

38 Council Directive 77/388/EEC, Common system of Value Added Tax: Uniform Basis of Assessment, 1977, available at <http://www.legaltext.ee/text/en/T60983.htm>. [Hereinafter, “Sixth Council Directive”]

39 PIERRE GUIEU, THE SIXTH COUNCIL DIRECTIVE ON VALUE ADDED TAX (UNIFORM BASIS OF ASSESSMENT) 11-15 (Kluwer, 1977); Alasdair Douglas, *A Taxing Problem for EU Accession States*, 34 Euro. Law. 29-30 (2003).

40 *Supra* note 16, at 211-212.

41 White Paper on the Completion of the Internal Market (June 1985), available at <http://www.ena.lu/white-paper-completion-internal-market-14-june-1985-020003520.html>.

42 Michael Keen, Stephen Smith, Richard E. Baldwin & Vidar Christiansen, *The Future of Value Added Tax in the European Union*, 11(23) ECONOMIC POLICY 375.

43 Council Directive 2006/112/EC, The Common System of Value Added Tax, 2006.

B. Refund Issues in the EU

Refunding the excess input credit in exports has been plagued with several issues in the EU. Refunds constitute a high proportion of the VAT collected by the EU. According to the IMF, the refunds accounted for 38.1% of the gross VAT revenue collected during the 4 year period of 1998-2001. Thereafter, 12 more countries, mostly Central and Eastern Europe have joined the EU – Bulgaria, Cyprus, Czech Republic, Estonia, Latvia, Hungary, Lithuania, Romania, Slovak Republic, Slovenia, Poland and Malta. Between 1998 and 2001, the IMF survey estimated the average of VAT refunds in Eastern Europe (consisting of Slovak Republic, Latvia, Hungary, Romania and Bulgaria) at 36.8% with countries like Slovak Republic registering estimates as high as 53.9% of the gross VAT revenue. Therefore, it is clear that in the EU, VAT refunds constitute a very large amount of the gross revenue collected by the governments.⁴⁴

The first set of problems arises from the fact that the procedure to claim refunds is extremely complicated and cumbersome. The Eighth Directive on VAT Reclaim deals with the procedure for claiming VAT refunds for persons within the EU. It provides a right of refund to every taxable person within the EEC.⁴⁵ The procedure requires:⁴⁶

- submission to a competent authority of the concerned state an application attaching originals of invoices or import documents;
- production of evidence, in the form of a certificate issued by the official authority of the State of the claimant, that he is a taxable person for VAT purposes in that State;
- furnishing a written declaration that she has supplied no goods or services deemed to have been supplied in the territory of the country during the period referred to in Article 7(1);
- undertaking to repay any sum collected in error.

The 13th Directive on VAT Reclaim applies to persons not belonging to any of the EEC member states.⁴⁷ It also provides the right to refund excess VAT to taxable

44 Harrison & Krelove, IMF Working Paper.

45 Council Directive 79/1072/EEC, art. 2, Arrangements for the refund of Value Added Tax to taxable persons not established in the territory of the country, 1979. [Hereinafter, "Eighth Council Directive"]

46 Eighth Council Directive, art. 3.

47 Council Directive 86/560/EEC, Arrangements for the refund of Value Added Tax to taxable persons not established in Community territory, 1986. [Hereinafter, "Thirteenth Council Directive"]

persons belonging to non-EEC states against EEC member states.⁴⁸ The procedure here is left entirely to the Member states with the only caveat that the procedure should not be any more favourable than the procedure provided for claimants from EEC member states.⁴⁹ The procedure here is potentially even more cumbersome and complicated as the burden of proof here would probably be greater.

As a consequence of such complications, there are companies that specialise in the VAT recovery and provide services for the recovery of VAT refunds in the EU. They often charge commission based on a percentage of the refunded VAT.⁵⁰ While big corporations with large refunds can at least employ the services of such groups, the smaller and mid-sized corporations can't really do the same. As a consequence, it is hardly surprising that firms often forgo these refunds which are left with the government. A recent study has indicated that 53.4% of the refundable cross-border VAT is not being claimed. The governments have been accused of inaction the status quo is adding billions in euros to their national treasuries.⁵¹

The second set of problems arises on the business side in the form of frauds. Although refunds are seen as strongly incentivising the payment of the VAT (leading to VAT being regarded as a "self-enforcing tax"),⁵² they are also a source of a lot of complex frauds. There are various forms these frauds take from the simple "missing trader" frauds to more complex forms of "Carousel frauds."⁵³ Altogether,

48 Thirteenth Council Directive, art. 2.

49 Thirteenth Council Directive, art. 3.

50 See, e.g., *TMF VAT & IPT Services*, available at www.tmf-vat.com; *The VAT Recovery Group (VRG)*, available at <http://www.vrg.biz/>.

51 http://www.tax-news.com/asp/story/story_open.asp?storyname=22207.

52 World Bank, *Course on Practical Issues of Tax Policy in Developing Countries*, Working Paper: *Value Added Taxation: Mechanism, Design, and Policy Issues* (April 28-May 1, 2003) (prepared by Tuan Minh Le).

53 "In its simplest form, this works as follows. Firm A, registered for VAT in one member state, imports goods from another. Under the deferred payment arrangements of the EU, it should account for the import VAT due in its next periodic return, crediting this amount against the output tax due on its own sales. Firm A does indeed invoice VAT to its customer, firm B, but fails to remit the VAT payable, and disappears. Firm B then exports the goods, and — on the strength of the invoice issued to it by A — claims a refund for VAT that has not, in fact, been paid. The goods, often high value items easy to transport (such as mobile phones or computer chips) are then brought back into the country once more, and the carousel keeps on turning. In practice, schemes are often (stunningly) more complex than this example, with buffer companies, perhaps perfectly innocent, placed between A and B, and/or more complex routing of goods. But the essence remains the generation of refund claims that do not correspond to VAT actually paid." Michael Keen, *VAT Attacks!* (International Monetary Fund, Working Paper No., WP/07/142).

these frauds are estimated to cost the European taxpayers over £170 billion every year, twice the budget of the EU.⁵⁴ The carousel fraud is found to constitute 1.5-2.5% of the VAT revenue of states like United Kingdom and Germany. In the UK, the total loss of the VAT revenue from all sources is estimated at 13.5%. Such frauds are a cause for concern not only because of the resulting revenue loss but also because they significantly distort trade statistics and consequently, throw a spanner in macroeconomic management.⁵⁵ The possibility and the prevalence of such frauds are also cited as a reason for the delay in refunds of excess VAT paid by the governments.⁵⁶

C. Responses

The EU has responded to these issues in various ways. First, as regards the complex and complicated procedure, the EU has introduced new VAT rules effective from January 1 2010, which considerably simplify the process of claiming refunds. Under the new rules, instead of furnishing a number of documents and original invoices, a claim for VAT refund may be made online via the internet and paper and electronic invoices will be treated equally. The new law also seeks to harmonise invoicing rules across the EU.⁵⁷ Such a move is expected to save €18 billion across Europe.⁵⁸

As regards tackling the VAT frauds, a defect recognised by the Commission of the European Communities in a Communication in 2007 was that the 1993 system for information exchange between Member States on intra-Community goods trade and supply doesn't provide relevant and timely information for efficient tackling of VAT fraud. Concerns were raised that the additional reporting requirements should not impose major difficulties on the business. To address this, it was decided that minimum standards for more frequent reporting must be incorporated into the legislative proposals at the EU level to combat the problem. It also was observed that member states need to take a more EU level view to facilitate a common functioning VAT system that will protect not only their own VAT revenues but

54 http://news.bbc.co.uk/2/hi/uk_news/7650883.stm

55 Michael Keen, *VAT Attacks!* (International Monetary Fund, Working Paper No. WP/07/142).

56 Harrison & Krellove, IMF Working Paper.

57 [http://www.ey.com/Publication/vwLUAssets/Indirect_Tax_Alert_edition_325/\\$File/Indirect%20Tax%20Alert%20edition%20325%20-%20Update%20-%20New%20VAT%20Rules%20for%20Crossborder%20Supplies%20of%20Goods%20and%20Services%20in%20the%20EU.pdf](http://www.ey.com/Publication/vwLUAssets/Indirect_Tax_Alert_edition_325/$File/Indirect%20Tax%20Alert%20edition%20325%20-%20Update%20-%20New%20VAT%20Rules%20for%20Crossborder%20Supplies%20of%20Goods%20and%20Services%20in%20the%20EU.pdf).

58 <http://www.internationaltaxreview.com/?Page=9&PUBID=210&ISS=25241&SID=716661>.

also the revenue of other Member states. A need for providing more up to date information of the register of taxable persons to the business community and enhancing the recovery powers of States in case of frauds was also felt.⁵⁹ These observations were incorporated in short term action plan recommended by the Commission in 2008 which included all of the above along with the formation of a European network 'Eurofisc' for early warnings on VAT fraud risks, *inter alia*.⁶⁰ Some of these suggestions were incorporated into a proposal⁶¹ that is being brought into effect from January 1 2010.

As regards carousel frauds in particular, new rules have been introduced to check frauds through "reverse charging" in the UK. This is in derogation of the EU rules for the VAT accounting that target the purchaser instead of the seller if the purchase is by VAT-registered business for business purposes. These new rules apply in cases of mobile phones, computer chips and certain other electronic devices.⁶² This is because it has been found that most carousel fraud happens in these high value goods. However, the UK has also been criticized for this as it has been opined that fraudsters would simply move to other high value goods for committing VAT frauds.⁶³

However, these measures are seen as inadequate and in academic circles, more radical suggestions have been made by some to check such problems. Way back in 1990, Hans Werner Sinn pointed out to the contradictions and problems in the common market, the clearing house approach and the application of the destination principle and suggested the application of the origin principle and the subtraction method instead of the invoice method.⁶⁴ However, the shift from destination principle to origin principle has been found to have certain

59 Communication to the Council concerning some key elements contributing to the establishment of the VAT anti-fraud strategy within the EU, COM (2007) 758 final.

60 Communication to the Council, the European Parliament & the European Economic and Social Committee on a Coordinated Strategy to Improve the Fight against VAT Fraud in the European Union, COM (2008) 807 final.

61 Proposal for a Council Directive amending Directive 2006/112/EC, Common System of Value Added Tax as regards the Rules on Invoicing, COM (2009) 21.

62 http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageVAT_ShowContent&id=HMCE_PROD1_025730&propertyType=document#downloadopt.

63 <http://news.bbc.co.uk/2/hi/business/6710827.stm>.

64 Hans-Werner Sinn, *Tax Harmonisation and Tax Compensation in Europe* (National Bureau of Economic Research Working Paper Series, Working Paper No. 3248), available at <http://www.nber.org/tmp/41033-w3248.pdf>.

distributional effects which make such a shift undesirable.⁶⁵ Furthermore, the subtraction method has been criticised for requiring an explicit estimation of the tax base which creates serious problems in a multiple VAT regime. The clearing house approach has still not been applied in the EU which still maintains its transitional system introduced in 1993.⁶⁶

Another problem with the origin principle is that, in the absence of harmonised tax rates across member states, it would operate in direct contravention of one of the basic principles of international trade law today i.e. the national treatment principle.⁶⁷ This is because the exporting states will charge as low a tax rate as possible in order to stimulate exports. Further, domestic goods and foreign goods will *inevitably* be treated unequally as the taxes are applied by different jurisdictions. Harmonisation of tax rates across jurisdiction is unlikely as each state imposes rates as per its own revenue requirements and it is the sovereign power of the state to fix its tax rates and structures. Such powers cannot be impeded by a body such as the EU without overwhelming state consensus which, so far, has not been forthcoming. In the absence of such harmonisation, it is impossible to apply the origin principle without a major overhaul of some basic principles in international trade today. Therefore, as of now, any change will have to be sought within the existing VAT framework.

IV. THE BRAZILIAN VAT

A. Historical Background

Brazil was the first major developing country to introduce the VAT. Significantly, it is also one of the few major federations to have introduced the VAT. Its history with the VAT has been a chequered one, affected by both, the eco-political situation of the country and the difficulties of implementing the VAT in a federation. Until the major tax reforms of 1965, the Brazilian government relied on very limited taxes and tariffs for the bulk of their revenues. The single stage wholesale consumption taxes and income tax accounted for 75% of federal revenues and the turnover sales tax was the most important source of revenue for states.⁶⁸ Subsequently, at the state level, the turnover tax was abolished and the VAT was

65 Hans Fehr, *From Destination- to Origin-Based Consumption Taxation: A Dynamic CGE Analysis*, 7 *International Tax and Public Finance* 43.

66 *Supra* note 42.

67 http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm.

68 Carlos Longo, *The VAT in Brazil*, cf *VALUE ADDED TAXATION IN DEVELOPING COUNTRIES* 121-128 (Malcolm Gillis, Carl S. Shoup and Gerardo P. Sicut eds., World Bank, 1990).

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introduced despite much opposition from the states.⁶⁹ Thereafter, the VAT at the federal level was also brought into effect.

B. *The VAT Structure*

Today, at the federal level, there is the IPI (Imposto sobre Produtos Industrializados) which is in operation whereas at the state level, the VAT is known as ICM (Imposto Sobre Operacoes Relativas a Circulacao de Mercadorias e Servicos).⁷⁰ The ICM was introduced based on an origin principle VAT system insofar as inter-regional trade was concerned. To prevent the complications created by lack of uniformity in tax rates in inter-state sales in an origin principle based VAT system, the Tax Reform Commission, prescribed the adoption of a federal rate ceiling on interstate and foreign sales coupled with the freedom for individual states to set their internal rates at higher levels. This led exports to be treated more favourably than interstate sales. However, this has not led to the autonomy of states as had been contemplated by the Commission.⁷¹

Brazil faces serious administrative problems in administering its VAT. It has been considered too complicated a tax structure which has severely subverted the states below the centre and allowed for a great amount of evasion. It is also an important example of how the origin principle, while avoiding the problem of refunds, has problems of its own unless properly implemented and administered. Evasion has become a commonplace problem with cross border shopping, false inter-state sales etc. have become commonplace.⁷²

C. *The Problem with Refunds*

The question of refunds arises in Brazil in the tax of international trade where the destination principle still applies. Here, it has been found that net exporting states are worse off than net importing states as the former is zero-rated.⁷³ Furthermore, goods for export are exempted from state level VAT under the 'Kandir Law'. This deprives states of their power to tax and adds an additional burden on the centre as it has to compensate the state for the lost revenue. This has contributed to the burgeoning national debt of Brazil where it was found

69 Michèle Guerard, *The Brazilian State Value-Added Tax*, 20(1) STAFF PAPERS - INTERNATIONAL MONETARY FUND 118.

70 Mahesh C. Purohit, *Value Added Tax in a Federal Structure: A Case Study of Brazil*, 32(7) ECONOMIC AND POLITICAL WEEKLY 357. [Hereinafter, "Purohit, EPW"]

71 *Supra* note 69, at 127-128.

72 Mukhopadhyay.

73 *Supra* note 68, at 128.

that more than half of the debt was accumulated in restructuring and refinancing sub-national debts.⁷⁴

The federal government imposes the IPI on raw materials, intermediary products and packaging materials. Those materials on entering into industrial establishments are credited against the tax liability of the final goods so long as the final goods are taxed and not exempt. The exception to this is in exports which are entitled to credits despite the zero rating. Exports are also exempt from IPI, in addition to being exempt from ICM as pointed above. In practice, however, it has been found to be a rarity to receive cash reimbursement for the credits accumulated from the government. This makes export credits practically non-refundable and this adds to the burden of the exporters.⁷⁵

A number of suggestions have been made and considered for improving the situation in Brazil from a destination based tax at state level, to a compensating VAT (C VAT) and an imitation of the Canadian VAT.⁷⁶ However, none of these suggestions were actually incorporated leaving the complexities and the problems in the old system untouched.

V. THE CHINESE EXPERIENCES

A. *Historical Background*

The system of taxation has undergone changes that are classified into four phases. Between 1949 and 1957, there was unification of legislative power to tax, methods of collection, categories and organs of taxation. For the next 20 years, efforts were made to simplify the tax system by combining the former goods tax, distribution tax, business tax and stamp duty into a unified business tax and the categories of tax were reduced. Thereafter, between 1979 and 1993, reforms in the business system were first seen and with that we see the tax for profits for state owned enterprises, emergence of the regulatory nature of taxation, the decentralisation of the business tax into central, local and local sharing taxes and the introduction of value added tax. However, it is from 1994 onwards that signs of a more typical value added tax system emerge. Collection of the VAT began

74 David Samuels, *Fiscal Straitjacket: The Politics of Macroeconomic Reform in Brazil, 1995-2002*, 35(3) JOURNAL OF LATIN AMERICAN STUDIES 545.

75 Purohit, EPW, at 360.

76 Purohit, EPW, at 360.

on nearly all links in the chain of industrial production and consumption tax was introduced in some of the areas.⁷⁷

B. The VAT System: A Unique Example

Despite the apparently typical structure of the VAT system, China is perhaps the most interesting example of a country implementing the VAT. It is an aberration in many ways from the international community generally in its VAT structure. Its VAT system is unique and hence, an interesting example to look at in the light of the VAT refunds in cross-border transactions.

China has what is regarded as an “*impure*” VAT system as it has evolved in a way which is considerably different from the evolution of the VAT elsewhere. In many ways, it operated like any other VAT system. It uses a multiple rate VAT system and operates on the destination principle. Exports are zero-rated while imports are taxed. However, certain imports are exempt from the VAT, namely imported machinery and equipment.⁷⁸ However, interestingly enough, the VAT is used more importantly in China as a stabilization device and to meet policy objectives rather than simply a revenue mechanism. Consequently, there are many points at which deviation occurs.⁷⁹

First, in China, the VAT was based on production and not consumption based as elsewhere until very recently. Capital goods were included within the VAT base. Additionally, most services are subject to a turnover tax, known as the business tax, which is not creditable against the VAT, but which accrues to local governments. This situation was strongly criticised for the distortions and cascading effect it created.⁸⁰ Only from January 1 2009 has China moved to a consumption VAT where companies are allowed to deduct input VAT for purchased capital goods/ fixed assets. If the output tax amount for the period is insufficient to completely offset input tax for purchased fixed assets in that period, the excess amount can be carried forward to subsequent periods.⁸¹

77 Zeng Guoxiang, *An Analysis of China's Taxation System and Its Future Development* (ATAX Discussion Paper Series No. 2), available at papers.ssrn.com.

78 <http://www.internationaltaxreview.com/?ISS=25227&PUBID=35&Page=10&SID=715717&TYPE=20>.

79 John Whalley & Li Wang, *Evaluating The Impure Chinese Vat Relative to a Pure Form in A Simple Monetary Trade Model with an Endogenous Trade Surplus* (National Bureau of Economic Research Working Paper Series, Working Paper No. 13581), available at <http://www.nber.org/papers/w13581>.

80 Ehtisham Ahmad, Raju Singh & Benjamin Lockwood, *Taxation Reforms and Changes in Revenue Assignments in China* (International Monetary Fund, Working Paper No. WP/04/125).

81 *Supra* note 79.

C. Structure of the Refund System

Refunds are one such area where deviation occurs. Although exports are zero rated, rebates of taxes paid on inputs vary by sector and commodity. Export rebates have evolved in a manner unrelated to the taxes paid on inputs. Also, in sectors like textile and clothing, the rebates are used in an on/off manner to stabilise the sector when export growth rates are seen as too high. Even areas where export rebates are limited, the limits have been varied several times.⁸² For example, in November 2008, refund rates were increased for the following goods, inter alia, in the following manner:⁸³

	Earlier Rate	New Rate
Rubber Tires and Forest Products made from Fast-Growing Materials	5%	9%
Some Metal Stamping Moulds and Glassware	5%	11%
Some types of Frozen Shrimp and Crab	5%	13%
Bags, Shoes, Maps, Umbrellas, Beddings, and Lights	11%	13%

Furthermore, between 2008 and 2009 alone, the VAT refund rate on textiles and clothing product has been changed four times: in August 2008 from 11% to 13%, in November 2008 from 13% to 14%, in February 2009 from 14% to 15% and to 16% from 1st April 2009. The justifications for this was to stabilise exports, secure domestic employment and facilitating industrial restructuring.⁸⁴

For claiming a refund in China, the claimant must show the following:⁸⁵

- (1) The claimant must be a "General VAT Taxpayer" and
- (2) Must procure a VAT Rebate Certificate granted by the Tax Bureau.

Only once this is shown will the claimant be allowed the refund.

82 *Supra* note 79.

83 <http://www.china-briefing.com/news/2008/11/19/new-vat-refund-rates-to-take-effect-dec-1.html>.

84 <http://www.bcecc.be/index2.lasso?Page=newsdetail&Lang=UK&ID=452>.

85 <http://www.hg.org/article.asp?id=5766>.

The problem with refunds in China is unique partly owing to its peculiar VAT structuring and partly generic to developing countries. The unique problems arise from the limitations on the refunds that are imposed on the refunds that can be claimed. They increase the transactional burden that is borne by the exporters. However, economically, it has been doubted whether the standard effects of such a practice apply to China due to its unique economic system with the “*fixed exchange rate, non accommodative monetary policy, inconvertibility and endogenous reserve accumulation.*”⁸⁶ In fact any pure VAT system, it was found, would result in a welfare loss as compared to the impure VAT operating there.⁸⁷

At the same time, China has some problems which are typical to developing countries. One such problem seen there, as recently pointed out by a local law firm, is the problem of the gap between law in book and law in practice. In China, the VAT refund claim has to be filed within 90 days. However, often, in practice, longer periods are allowed by local tax authorities. Since this practice is carried out in an unofficial manner, often the practice is replaced by the statutory requirements overnight and firms suffer as a consequence. These firms are mostly unaware of the practices and rely on local persons to get it right. In such situations, exporters often pay a high price.⁸⁸

VI. THE INTERNATIONAL EXPERIENCE: CONVERGENCE AND DIVERGENCE

As we see the three VAT systems, a mosaic of similarities and differences emerge. Each of these systems incorporates VAT in different ways. The policy and ideological basis for the implementation differs in fundamental ways in these systems. However, despite this, there are some important points of convergence that must also be noted. The findings can be summarised in the following manner:

- *The general issues that the states struggle with are the same: Broadly, the issues that arise in the countries are the same. There are problems of frauds being committed on the part of the taxpayers and delays, bureaucratic hurdles and inefficiencies on the government's part in paying the refund. The manner in which they manifest themselves might sometimes be distinct and unique like in the case of Chinese local tax authorities. However, in their essence, the issues remain the same.*

86 *Supra* note 80.

87 *Supra* note 80.

88 *Supra* note 84.

- *Both, VAT systems and solutions vary from one state to another:* None of the VAT systems this paper has dealt with are alike. They are all specific to the socio-political context in which they operate. In case of Brazil, we see a centre-heavy federation and a rigid and complicated tax structure which is partly based on the destination principle (insofar as exports are concerned) and interstate VAT which is based on the origin principle. In case of China we see an impure VAT which would have been unsuitable in an ordinary liberal economy is found to be most suitable for China. It imposes limits on the extent to which input credits may be refunded and changes the manner in which the VAT operates quite frequently. On the other hand, in the European Union, almost every aspect of the VAT other than VAT rates has been harmonised across Member States and we see perhaps the most sophisticated VAT system of the three.

At the same time, due to the differences between their VAT systems, the solutions for the issues they face around VAT refunds also have to vary. While Brazil's top priority would probably be a large scale overhaul of their tax structures and simplification of the same, China would need to oversee the enforcement of its laws at the ground level. The European Union, on the other hand, needs to simplify its procedures and ensure constant vigilance to overcome the issues of delays in refunds and VAT frauds. This needs to be understood before legal/policy prescriptions are made to countries based on the experiences of another. Each country has its own hurdles; its own socio-political backgrounds which must be taken into account while addressing these issues. Blind borrowing of ideas from other states may be ineffectual at best and disastrous at worst.

- *The problems in VAT systems are more administrative/ procedural than legal:* It is the submission of the author that it appears that the issues surrounding the VAT are a result of flawed administration or policies rather than simply flawed legislations. In all three jurisdictions, the issues surround detection and enforcement rather than the legal protection afforded. There is no real legal alternative as such to address many of the issues that surround VAT refunds. The origin principle based VAT taxation is hardly an option as it militates against the national treatment principle on which international trade is based. Therefore, the solutions to the issues have to be found within the administrative and policy domain. Radical alternatives as such are not really alternatives. Perhaps, the partial exception to this is Brazil that also faces the problem of an over-complicated VAT structure. However, it too faces administrative issues which, if unchecked, will make any legal/structural changes of little significance.

VII. CONCLUDING REMARKS

"Tolstoy has it that all happy families are alike, but every unhappy family is unhappy after its own fashion. Much the same is true of the VAT. If it functions as it should, any VAT is indeed simply a uniform tax on final consumption, to which all our simple textbook models in principle apply. But a less than perfectly functioning VAT is an analytical mess, with particularities of production relationships and compliance behaviour immediately becoming key. And it is imperfectly functioning VATs that we observe in practice and need to understand better."

- Michael Keen⁸⁹

Thus, as we see it, the problems with VAT refunds are both, global and local. The experiences are broadly similar though their manifestations may differ at the ground level in each state. The problems have to be tackled within the broad system of destination based VAT as an origin based VAT is inconsistent with the current international trade laws and practices. Although the issues relating to VAT refunds cannot be done away with entirely, they can certainly be minimised through targeted efforts.

89 *Supra* note 56.