هيئة الزكاة والضريبة والجمارك
Zakat, Tax and Customs Authority

How VAT works

December 2022

Key policy and operational dimensions of a sound VAT system

Agenda for today's session

1 **Understand VAT's mechanics and process**

Review how VAT works along the value chain taking a real-life case example

2 **Explore key design elements of a sound VAT system**

Discuss the main dimensions of a sound VAT system, including e-invoicing, tax rates, exemptions, thresholds, assessment and special schemes

3 **Overview of key operational features of VAT administration**

Review VAT's management and administration dimensions and VAT's main operational features in a digitized context

Contents

Key reminders, concepts and features on VAT

Input & output VAT

Input VAT corresponds to VAT that VAT taxable persons incur on their acquisitions (i.e., VAT paid on invoices issued by their suppliers)

Output VAT corresponds to VAT that VAT taxable persons assess on their supplies (i.e., VAT received from invoices paid by customers)

Payable or receivable VAT corresponds to the difference

Right to VAT deduction

VAT is neutral along the value chain because businesses have the right to deduct input VAT (i.e., VAT they pay to their suppliers)

VAT taxable persons are entitled to claim VAT paid on acquired goods and services (so-called input VAT)

Only the final consumer will bear the final VAT because it has no right to deduct VAT that it pays for goods and services

VAT assessment

Typically, VAT is collected from customers by suppliers

VAT withholding: aimed at preventing non-compliance, by forcing selected customers to withhold VAT on payments to suppliers

Reverse charge: transfers VAT assessment from suppliers to customers; invoice issued without VAT and VAT is self-assessed by customers (typically used to collect VAT on the supply of foreign services to local VAT taxable persons)

VAT credits/refunds

Balance between input VAT and output VAT could be positive or negative

If positive, VAT liability is due to Treasury

If negative:

a) VAT credit roll-over setoff against subsequent VAT periods; or

b) VAT refund request (typically, if credit is not used after a time and the amount exceeds the threshold)

VAT exemptions

VAT exemptions are two-fold:

a) the supply is exempt, but the supplier is not entitled to claim input VAT (so-called “incomplete exemptions”) – e.g., health, education, financial services

b) the supply is exempt, but the supplier is entitled to claim input VAT (so-called “zero-rated supplies”) – e.g., exports of goods and services

Value Added Tax – Snapshot over KSA's VAT

Taxable base	Imports and domestic supplies of goods and services; VAT along the value chain is computed based on the difference between output VAT (VAT on sales) and input VAT (VAT on acquisitions), the difference being passed on to ZATCA so that only the final consumer bears the final VAT burden (if > VAT payment; if < VAT refund)
Taxable persons	VAT registered companies and self-employed/professionals with annual turnovers exceeding SAR 375K (~USD 100K)
Exemptions & exclusions	Exports of goods and services (zero-rated supplies) Domestic exemptions apply (e.g., real estate, healthcare and education (except expats), financial services, etc)
Tax rate	Standard: single 15% VAT tax rate (5% prior to 1 July 2020)
Filing & compliance	Monthly VAT return: VAT taxpayers with annual turnover exceeding SAR 40M (~USD 10M) and quarterly VAT return: all other VAT registered taxpayers; filing deadline until the end of the month following the end of the tax period to which the VAT return relates (e-filing available)
Payment & collection	VAT payment deadline coincides with deadline for filing monthly VAT return (e-payment available)
Special schemes	VAT cash accounting scheme and VAT bad debt relief available for SMEs, subject to certain conditions being met

Typical process of VAT collection and recovery along the value chain

	Rice from farmer	Bag from supplier	Wholesaler	Supermarket	Consumer
Selling price (excluding VAT)	50	10	80	100	
Applicable tax (15%)	7.5	1.5	12	15	
Total Invoice	**57.5**	**11.5**	**92**	**115**	
Output VAT collected	7.5	1.5	12	15	0
Input VAT paid	*Assuming no inputs*		2 -9	3 -12	0
VAT collected along the value chain	**7.5**	**1.5**	**3**	**3**	**15**

1. Wholesaler buys two inputs (rice and bag) and pays VAT on both inputs
2. Wholesaler recovers VAT on inputs
3. Supermarket buys rice bags from wholesaler and recovers VAT
4. Consumers buy rice bag and bear tax on end price

The impact of zero-rated VAT on the collection and recovery of VAT along the value chain

Selling price (excluding VAT)	50	+	10		80		100		
Applicable tax (15%)	0	+	1.5		0		0		
Total Invoice	**50**	+	**11.5**		**80**		**100**		
Output VAT	0	+	1.5		0		0		0
Input VAT	*none*			2	-1.5		0		0
VAT collected along the value chain	**0**	+	**1.5**	–	**1.5**	+	**0**	=	**0**

1. Wholesaler buys two inputs (rice and bag) and pays VAT on non-essential input (bag)
2. Wholesaler recovers input VAT on the bag, since the supply – sale of rice – is zero-rated
3. Supermarket buys rice bags from wholesaler
4. Consumers buy rice bag from supermarket

The difference between zero-rated and exempt VAT on the collection and recovery of VAT

	Rice		Bag		Wholesaler		Supermarket		Consumer
Selling price (excluding VAT)	50	+	10		81.5		100		
Applicable tax (15%)	0	+	1.5		0		0		
Total Invoice	**50**	+	**11.5**	2	**81.5**		**101.5**		
Output VAT	0	+	1.5		0		0		0
Input VAT	*Assuming no inputs*				0		0		0
VAT collected along the value chain	**0**	+	**1.5**	+	**0**	+	**0**	=	**1.5**

1. Wholesaler buys two inputs (rice and bag) and pays VAT on non-essential good input (bag)
2. Non-recoverable VAT gets incorporated into the price (tax cost passed on to price)
3. Supermarket buys rice bags from wholesaler (hidden VAT passed on to price)
4. Consumers buy rice bag and bear tax on end price (end-product more expensive)

Key considerations and implications of VAT exemption vs zero-rated

	VAT exemption	Zero-rated VAT
	Goods and services are fully exempt from VAT **Input VAT cannot be recovered**	**No VAT is collected on supplies of goods and services** **Input VAT can be fully recovered**
Consumers	Impact of hidden VAT on prices (non-deductible VAT passed on to final prices)	Neutral impact on prices (VAT deductibility enables price neutrality)
Tax Authority	Revenue loss mitigated by hidden VAT effect (cascade effect)	Enhanced revenue loss (no VAT collection and input VAT claim)
Operations	Increased risk of allocation of non-deductible VAT to taxable supplies by partly exempt taxpayers	Increased pressure over the VAT credit and refund mechanisms

Findings

VAT exemption impacts prices vs zero-rated supplies

Zero-rated supplies lead to higher revenue loss

Zero-rated supplies require additional effort to process and monitor VAT refunds

Contents

VAT key design elements

How broad is the base of exemptions?

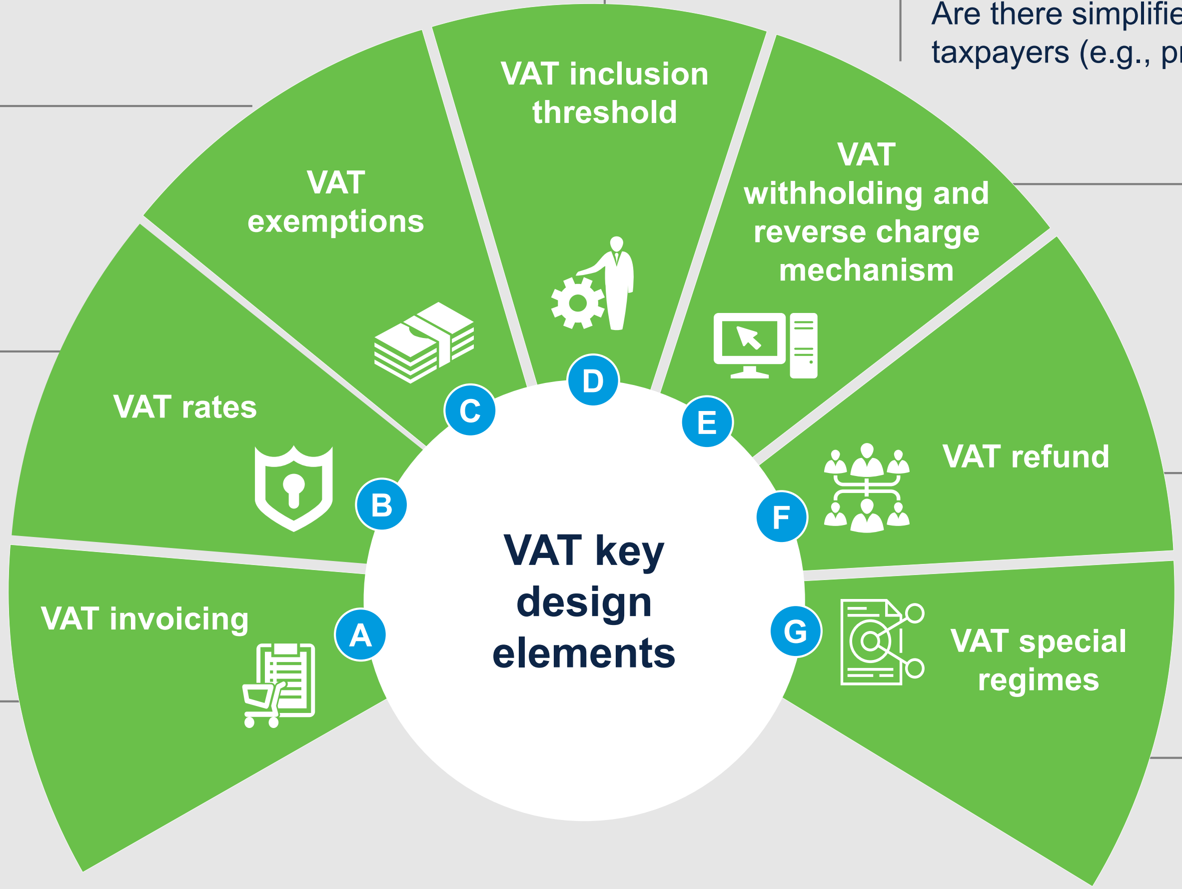
Are standard VAT rates in line with regional/global peers and local revenue targets?

Is the VAT system single-rated? How many VAT rates are in use?

Are VAT invoicing systems standardized and certified?

Is e-invoicing mandatory for top taxpayers?

Is SAF-T or similar accounting software being used by VAT taxpayers?



Is there a mandatory VAT inclusion threshold?

Is the threshold adequate to the taxpayers' local profile?

Are there simplified regimes to small and medium sized taxpayers (e.g., presumptive/deemed taxation)?

How is VAT assessed (e.g., VAT withholding and reverse charge)?

Are there any limitations on VAT right to deduction in line with international best practices?

Is the VAT refund process aligned with best practices and standard procedures?

Is there cash accounting VAT applicable to SMEs and VAT recovery for bad debts?

A. Countries evolved from paper-based to digitized invoicing systems, preventing tax evasion, increasing audit effectiveness and expediting administrative processes

From…	To…	Towards…
Paper invoices of inconsistent format, which delay the conduct of audits	Standardised electronic invoices that facilitate expedited audits	Processing of standardised invoices on a mass scale through automated algorithms
Invoices dispersed randomly across taxpayer facilities	Invoices can be accessed in a centralised e-depository, expediting invigilation drives	Invoices can be assessed in real-time by tax administrations
Taxpayers often issue more than one invoice for the same transaction	Each transaction has a unique identifier, preventing underreporting of VAT outputs and overreporting of VAT inputs	VAT inputs and outputs are automatically reconciled across the value chain, flagging underreporting of outputs and overreporting of inputs automatically
Invoices forged and deleted by fraudulent taxpayers (e.g., eliminating sales)	Manipulation of invoices is prevented thanks to certification of softwares by tax administrations	Tax administration is automatically notified of any discrepancies and the system sends out automated notices to taxpayers

A. The implementation of digitized e-invoicing systems is normally deployed under three different models

Most common

	Centralized e-invoicing model	De-centralized e-invoicing model	Blockchain enabled VAT invoicing scheme
Description	Invoices are subject to pre-approval by the tax administration or third-party contractor prior to their issuance to consumers	Invoices are issued to consumers through certified invoicing software and periodically reported to the tax authority by suppliers	Platform to issue blockchain backed VAT invoices
Advantage	• Enables real-time access to business transaction data • Enables large scale reduction of fraudulent invoicing	• Low upfront investment required for the tax authority • Decentralization helps mitigate the risk of IT system failures impacting day-to-day business activity	• Enables automated generation of unique receipts online or using a mobile app which helps to: – Reduce the number of fraudulent invoices – Improve the supervision of the invoice issuing process – Reduce time and cost of the process through automation
Disadvantage	• High upfront investment • Requires reliable IT infrastructure for validation of e-invoices	• Delays the access to data on business transactions by the revenue authority	• Requires significant up front investment to build blockchain invoicing online platform/application

B. Four types of VAT rates are observed worldwide

	VAT standard rates	VAT reduced rates	VAT flat rates	VAT increased rates
Description	Consumption tax assessed on the **value added to goods and services**	Aimed at **stimulating consumption** (e.g., cultural products) and **alleviate VAT burden** on essential goods and services (e.g., utilities)	Designed to enable smaller businesses above the VAT threshold to **pay VAT with lower compliance costs** (no input VAT claim is allowed)	Aimed at **increasing revenue from selected sectors** of the economy (e.g., Jamaica collects 25% vs. 15% VAT from phone services)
Target group	All goods and services except for exempted and zero-rated	Suppliers of basic and essential goods and services	Small businesses (UK) / Wholesale & Retail Traders (Ghana)	Selected services such as telephone services, TV broadcasting services, banking
Case examples	166 countries globally (virtually every country applying a VAT)			

Source: Consumption tax trends report 2020

B. The existence of multiple rates raises numerous implementation challenges

Challenge	Summary
Administrative and compliance costs	As the number of rates increases, VAT tax returns become more complex and the possibility of error by the taxpayer and tax administration is greater, increasing the risk of fraud[1]; compliance costs also increase (e.g., accountants, IT system adjustments, etc)
Lack of impact on price and consumption habits	Lower rates do not necessarily benefit the final consumer; prices could be adjusted according to the market and not according to the tax, so much so that there is evidence that the rates initially chosen do not impact the consumption of citizens[2]
Regressivity	Lower rates mainly benefit households with greater purchasing power. The policies intended to be pursued with these rate reductions could be better pursued through the government budget via subsidies/direct cash transfers
Complexity in tax management	It can sometimes be difficult to classify products subject to the standard rate and the reduced rates (e.g., fresh vegetables). Definition by means of a list can be complex, while also giving rise to inequalities and litigation

1 . When VAT was introduced in Ireland, the fact that there were 2 rates of tax meant that 38 fields had to be filled in

2. The decrease in VAT in restaurants in Portugal and France was not accompanied by a decrease in the price of meals, with taxable persons absorbing the entire margin

Source: Consumption tax trends report 2020

C. Although VAT exemptions narrow the VAT base, they are still usually adopted by most countries due to three main reasons

Rationale	Description
Activities whose value is difficult to determine	• The value added by certain activities (e.g., financial, insurance) cannot be easily calculated • The revenue potentially generated by the taxation of other activities (e.g., small-scale agriculture) is not substantial
Mitigating the regressive effect of VAT	Providing exemptions on products most consumed by low-income taxpayers helps alleviating the level of regressivity of VAT, although it benefits all taxpayers
Public acceptance of the tax	The exemption of essential goods and services (and the aggravated taxation of luxury goods) promotes the perception of the tax as fair and equitable, consequently fostering its acceptance by the wider public

C. However, VAT exemptions can significantly undermine revenue collection

Erosion of the tax base

Substantial sections of the economy could fall outside the scope of VAT taxation

Cascading taxation and price increase

Neutrality of the tax is disrupted (input VAT not-recoverable), pushing the suppliers of exempt goods and services to increase their prices (transfer the tax cost to customers)

High administrative complexity

The existence of taxpayers engaged in partially exempt transactions complicates the management and control of VAT operation, requiring complex deduction (pro-rate) and monitoring methods

Market constraints and distortions

The non-deductibility of input VAT provides an incentive for increased vertical integration

D. There are three main approaches to the registration of taxpayers for VAT

Approach		Countries	Rationale for adoption
Mandatory registration for all		Ghana Botswana Kenya Rwanda	Significantly expands the tax base Significant incentive to the formalization of the economy
Mandatory registration for all above turnover limit…	**…and voluntary scheme for those below the limit**	South Africa South Korea	Moderately expands the tax base Promotes the competitiveness of micro and small enterprises with capacity for tax management
	…but no voluntary scheme for those below the limit	Singapore	Facilitates tax management, excluding smaller businesses with no business organization

Key takeaways

Sound **VAT registration** is key to ensure solid VAT management

Introducing a **voluntary scheme for businesses below the VAT inclusion threshold** fosters adherence and expands the tax base

Calibrating the threshold **aligns VAT with local economy** and compliance levels and capability of taxpayers

Source: Tax guides published by specialized companies; websites of the TA of the respective countries; specialized articles (e.g., International Tax Review)

E. It is standard practice to use VAT reverse charge mechanism for imported services

Approach		Country	Import of services	Import of goods
Reverse charge	In most countries, reverse charge rules apply to the acquisition of services by resident taxpayers from non-resident entities In these cases, the customer becomes liable for VAT on the acquisition and the obligation to assess and account for VAT is shifted from the service provider to the customer (only applies to VAT taxable persons)	Mexico	✓	✓
		Portugal	✓	✗
		South Africa	✓	✗
		Zambia	✓	✗
		South Korea	✓	✗
		Singapore	✗	✗
		New Zealand	✓	✗

Key takeaways

Reverse charge mechanism **ensures VAT is captured** on the acquisition of foreign services

Local businesses **self-assess VAT on foreign supplier's invoice and deduct input VAT** on the acquisition of such services

Source: Tax guides published by public and private international institutions

E. However, in domestic transactions, withholding VAT is more frequent

Sample	Domestic reverse charge	Withholding VAT
Mexico	✗	✓
Portugal	✓[1]	✗
South Africa	✗	✗
Zambia	✗	✓
South Korea	✗	✗
Singapore	✗	✓[2]
New Zealand	✗	✗

1. Construction services; waste and scrap and other recyclable materials consisting of ferrous and non-ferrous metals; services that have significant greenhouse gas emissions
2. Mobile phones, memory cards, software

Source: Tax guides published by public and private international institutions

Key takeaways

Domestic reverse charge

- The person supplying the goods or services issues an invoice without assessing VAT
- The person acquiring the goods or services carries out a self-assessment of the tax within the respective deadlines and deducts the input VAT

Withholding VAT

- The person supplying the goods or services issues an invoice with a VAT assessment
- The person acquiring the goods or services collects/withholds the tax and pays it to the Government vs paying VAT to the suppliers (as usual)

E. Deductions can be controlled on a case-by-case basis or through general restrictions

Rationale for control

There are certain goods or services that may be used for **private consumption**, but classified as **professional expenses** (e.g., meals, vehicles, fuel, etc)

Countries require some limits to the VAT right to deduction to avoid fraud and evasion

Control mechanism

Case-by-case analysis of each invoice

- + Higher degree of fairness
- − Significant difficulty for tax authority
- − Increased risk of abuse

General restrictions to the right to deduct

- + Greater ease of administration
- + Lower risk of abuse
- − Occasional exclusion of legitimate costs

The imposition of general restrictions is recommended by international bodies as the most effective way to limit the extent of system abuse (use of artificial input VAT)

E. KSA deduction regime is broadly in line with that of peer countries

	Entertainment expenses	Purchase and hiring of motor vehicles	Jewelry and Annuities of recrea-tional clubs	Nautical and recreational craft	Fuel	Offers and gifts	Conferences and seminars	Professional travel and transport	Fixed assets	General expenses and administration	Telephone and electronic communications
Mexico	✓	✓	✗	✗	✗	✗	✓	✓	✓	✓	✓
Portugal	✗	✗	✓	✓	✗/50%	✗ > €50	✗	✗	✓	✓	✓
South Africa	✗	✗	✗	✓	✓	✗	✓	✓	✓	✓	✓
South Korea	✗	✗	✓	✓	✓	✓	✓	✓	✗	✓	✓
Singapore	✗	✗	✗	✓	✓	✓	✓	✓	✓	✓	✓
New Zealand	✗/50%	✗	✗	✓	✓	✓	✓	✓	✓	✓	✓
KSA	✗	✓	✗	✗	✓	✗	✗	✓	✓	✓	✓

Purchase of motor vehicles and fuel used for both business and personal usage bear exceptions in some countries to prevent overuse and abuse, e.g.,:

Portugal : Assume a % of the VAT as business input and therefore VAT deductible

UK: Uses detailed breakdown of the expense to define VAT deduction (e.g., detailed mileage records to separate business mileage from private mileage, and taxpayers can deduct the corresponding %)

Source: Tax guides published by public and private international institutions

F. VAT refund process should address the balance of competing needs between a streamlined process and required safeguards

VAT refunds

VAT refunds should strike a balance between the needs of taxpayers and tax administrations

Taxpayers

Need for quick and easy refunds in order to prevent cash flow pressures

Tax Administration

Need for processing times and requirements that enable the effective mitigation of tax evasion

Minimum time requirement	It is generally expected that, in the normal course of its business, the taxpayer will assess more tax than it deducts, and the mandatory carry forward will eliminate the credit of forward tax, preventing refunds
Performance of audits	The Tax Administration may reserve the right to carry out compulsory audits prior to the reimbursement, suspending the legal deadline for reimbursement while the audit is in progress
Provision of guarantee	The Tax Administration may require guarantees of available funds for a certain period after reimbursement to allow the recovery of tax if necessary (e.g., after a tax audit being conducted)
Minimum refund amount	Only claims above a certain threshold may be subject to a claim for reimbursement in order to avoid the allocation of public resources to small claims
Offsetting with other taxes	VAT credits can be used to offset other taxes (customs, income tax, withholding taxes, etc.)

G. Cash VAT has many potential benefits, but is not suitable to all contexts

Cash VAT can…

Help small businesses alleviate cash flow pressures by delaying VAT payments until they have the required cash at hand to comply

Prevent bad debt schemes, which can be technically complex for Tax Administrations to roll out and feature limited recoverability of tax

However, Cash VAT also…

Cannot be deducted until fully paid (which is not optimal for businesses that purchase on credit)

Requires additional reporting obligations and greater control by Tax Administrations to avoid fraud

G. Cash VAT is formally in place in KSA with a similar threshold as in other countries, but more stringent requirements

Country	Cash accounting available?	Annual turnover requirement
Australia	✓	**<** ~ SAR 26 M
United Kingdom	✓	**< ~** SAR 6 M
KSA	✓	**< SAR 5M**
New Zealand	✓	**<** ~ SAR 5 M
Singapore	✓	< ~ SAR 3 M
EU union wide	✓	**< ~ SAR** 2 M
Bahrain	✗	NA
UAE	✗	NA
Oman	✗	NA

Cash accounting in KSA

Description:

VAT on sales is accounted for **when payment is received** rather than invoiced
VAT on acquisitions is accounted for **when payment is made** rather than invoiced

Requirements:

VAT cash accounting requires filing an application form, prior approval from ZATCA and formal notification

Criteria:

Businesses whose sales do not exceed SAR 5 MN annual supplies

~ 65% taxpayer eligible to threshold

~5% total revenue of VAT

Key insights

- KSA seems to have a similar threshold to benchmarked countries
- "strict" application and approval process

Source: KSA VAT guidelines, Oman VAT guideline, UK government, Australian taxation office

G. Most countries offer relief for VAT bad debt with varying time frames

Country	Bad debt relief available?	Requirement for debt period
KSA	✓	> 12 months
Bahrain	✓	> 12 months
UAE	✓	>6 months
Oman	✓	>12 months
United Kingdom	✓	>6 months
New Zealand	✓	*To be confirmed*
Australia	✓	>12 months
Singapore	✓	>12 months

VAT bad debt relief in KSA

Description:

Businesses that have **not been paid** by their customers for **more than a given period** after the due date can claim relief from the VAT paid on the bad debts

Procedure:

VAT bad debt relief requires filing an application form, documents such as legal procedure confirmation, prior approval from ZATCA and formal notification

Criteria:

- A period of at least twelve months has passed from the date of the Taxable Supply
- Formal legal procedures must have been taken to collect the debts without success (e.g., court order) if total amounts unpaid >(100,000) riyals
- The consideration is in respect of a supply of goods or services made to a person who is not a related person
- Cannot use this scheme if using cash accounting

Key insights

- KSA currently requires similar time frame required for debt period to benchmarked countries
- KSA already applies strict criteria including proof of legal procedures taken

Source: KSA VAT guidelines, Oman VAT guideline, UK government, Australian taxation office

Contents

Tax Administrations could streamline registration, expand data collection and enable e-filing

	Initiatives	Tactical implementation steps
Registration	**Streamline registration**	• Set up online system that enables taxpayers to register for VAT without going to local tax branches • Mandate taxpayers to inform Tax Administration about changes in their registration status through a standardised form within the online system
	Enhance data collection	• Modify current VAT registration form to include additional information that could be collected in order to facilitate audits (e.g., business turnover, number of employees, ownership of real estate, shareholders) • Link VAT taxpayer profiles to ID numbers and to information from other databases (e.g., CIT filings) • Import data from third party providers (e.g., public utilities suppliers, Land Registry) to improve quality of profiling
	Mobilise SMEs	• Launch mobile units, linked to data systems, enabling taxpayers to register, file and pay VAT payments • Leverage units to conduct taxpayer registration drives across the country, starting in areas with high informality
Filing	**Enable e-filing**	• Adopt digital interface that enables taxpayers to file and amend electronic VAT returns online • Provide comprehensive e-filing guidance in order to accelerate adoption of new filing formats (e.g., through extensive FAQs, call centre, VAT return instructions)
	Expand evidence base	• Broaden the scope of the documents that taxpayers are required to submit alongside their tax return (e.g., including list of all suppliers, records of stocks and inventories) • Configure online system to enable the submission and processing of supporting documents
	Digitise paper returns	• Roll out a system that enables the swift scanning and digitisation of paper returns • Link scanning system with other databases to facilitate treatment of tax return data and conduct of follow-up analysis

Tax Administrations could also optimise risk flagging, automate audits and expand e-payment

	Initiatives	Tactical implementation steps
Audit assessment	**Enhance public engagement**	• Set up anonymous fraud call line and online “whistle-blower” form in order to enable citizens to report cases of tax fraud • Standardize process for handling of fraud reports to ensure that whistle-blower information remains reliable
	Improve risk flagging	• Enable online system to automatically notify Tax Administration about upcoming filing / payment deadlines • Issue automated warnings to audit teams at tax offices about taxpayers who do not file VAT returns / who do not pay tax
	Optimise selection of audit cases	• Create a risk profile for every taxpayer based on their past record / their sector (e.g., assigning a higher risk to taxpayers in sectors that are vulnerable to tax fraud) • Use algorithms to select taxpayers for audit, leveraging on their risk profile as well as changes in behavior patterns
	Increase auto-mation in audits	• Conduct automatic verification of input VAT and output VAT to identify underreporting of VAT by suppliers • Cross-reference VAT returns with CIT / Customs filings to uncover untapped potential sources of revenue
Collections & enforcement	**Expand e-payments**	• Mandate e-payments of VAT for all LTOs (e.g., through bank portals, mobile payment apps) • Launch campaign to achieve a voluntary adoption of e-payments by 70% of MTOs and STOs (e.g., through advertising)
	Automate legal notices	• Issue automatic legal notices for debt collection to taxpayers who have overdue VAT debts, leveraging contact information on databases • Automatically escalate high-value missed payments and submitted refunds to audit and enforcement teams
	Optimise debt recovery	• Coordinate with banks in order to ensure the swift recovery of debtor assets from accounts at financial institutions • Improve flow of data between Tax Administration and public enforcement authorities to reduce delays in the implementation of debt recovery measures

1. Other countries have adopted each of these initiatives – example mentioned next to each initiative is not exhaustive